CLERK'S COPY

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1945

No. 36

THE JOHN KELLEY COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR CERTIORARI FILED FEBRUARY 14, 1945.

CERTIORARI GRANTED APRIL 30, 1945.

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1944.

No.

THE JOHN KELLEY COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

INDEX.

TRANSCRIPT OF RECORD

In the United States Circuit Court of Appeals For the Seventh Circuit

No. 8426

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE JOHN KELLEY COMPANY,
Respondent.

Petition for Review of Decision of the Tax Court of the United States.

THE DONNELLEY-WARREN PRINTING COMPANY, 350 WEST JACKSON, CHICAGO

TRANSCRIPT OF RECORD FILED OCT. 4, 1943.
PRINTED RECORD.

In the

United States Circuit Court of Appeals

For the Seventh Circuit

No. 8426

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE JOHN KELLEY COMPANY,
Respondent.

Petition for Review of Decision of the Tax Court of the United States.

D. J. 114[illegible] The Gunthorp-Warren Printing Co., Chicago—12-7-43—50

INDEX

1 The John Kelley Company,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 109088.

Appearances:

For Taxpayer: E. H. Davis, Esq., Frank J. Albus, Esq.

For Comm'r: John D. Kiley, Esq.

DOCKET ENTRIES.

1941

Nov. 5—Petition received and filed. Taxpayer notified. Fee paid.

Nov. 5—Copy of petition served on General Counsel.

Dec. 9—Answer filed by General Counsel.

Dec. 9—Request for hearing in Indianapolis, Indiana filed by General Counsel.

Dec. 11—Notice issued placing proceeding on Indianapolis, Ind. calendar. Answer and request served.

1942

Apr. 8—Hearing set May 18, 1942 in Indianapolis, Indiana.

May 18—Hearing had before Mr. Turner on the merits. Submitted. Respondent granted leave to file amended answer. Amended answer filed. (Copies served.) Appearance of Frank J. Albus, Esq. filed. Stipulation of facts filed. Briefs due July 15, 1942. Replies Aug. 15, 1942.

June 20—Transcript of hearing 5-18-42 filed.

June 23—Supplemental stipulation of facts filed.

July 9—Brief filed by General Counsel. Served 7-15-42.

July 15—Brief filed by taxpayer. 7-15-42 Copy served.

Aug. 22—Motion for leave to file the attached reply brief, brief lodged filed by taxpayer. 8-22-42 Granted.

Aug. 24—Copy of motion and reply brief served on General Counsel.

Dec. 5—Stipulation re correction in "Exhibit F" filed.

1943

Jan. 15—Findings of fact and opinion rendered, Turner, Judge, Div. 8. Decision will be entered under Rule 50. 1-18-43 Copy served.

Feb. 2—Computation of deficiency filed by General Counsel.

Feb. 9—Hearing set March 3, 1943 on settlement.

Feb. 17—Consent to settlement filed by taxpayer.

Feb. 19—Decision entered, Turner, Judge, Div. 8.

May 18—Petition for review by U. S. Circuit Court of Appeals, 7th Circuit, filed by General Counsel.

May 18—Statement of points filed by General Counsel.

May 18—Notice of filing petition for review and statement of points (sent to Frank J. Albus) filed.

2 May 21—Proof of service of filing petition for review and statement of points filed. (Frank J. Albus.)

May 25—Proof of service of filing petition for review and statement of points filed by General Counsel.

June 23—Motion for extension to 8-16-43 to transmit record filed by General Counsel.

June 23—Order enlarging time to Aug. 16, 1943 to prepare and deliver the record entered.

Aug. 11—Certified copy of order from the U. S. Circuit Court of Appeals, 7th Circuit, extending the time to Oct. 16, 1943 to file the record filed.

Sept. 17—Designation of contents of record filed by General Counsel with proof of service thereon.

3 UNITED STATES BOARD OF TAX APPEALS.

The John Kelley Company,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket Number 109088.

PETITION.

(Filed Nov. 5, 1941.)

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, symbols IT:C:EK, dated August 11, 1941, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation with principal office at Second and Washington Streets, Marion, Indiana. The returns for the periods here involved were filed with the Collector of Internal Revenue at Indianapolis, Indiana.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on August 11, 1941.

3. The taxes in controversy are income and excess profits taxes for the calendar years 1937, 1938, and 1939 in the following amounts:

Year	Income Tax	Excess Profits Tax
1937	$ 569.06	$360.00
1938	1,980.00	None
1939	1,980.00	None
Totals	$4,529.06	$360.00

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) In computing the taxable net income of the petitioner for the calendar year 1937, the Commissioner refused to allow as a deduction from gross income interest paid or accrued during the year in the amount of $6,000.00.

(b) In computing the taxable net income of the petitioner for the calendar year 1938, the Commissioner refused to allow as a deduction from gross income interest paid or accrued during the year in the amount of $12,000.00.

(c) In computing the taxable net income of the petitioner for the calendar year 1939, the Commissioner refused to allow as a deduction from gross income interest paid or accrued during the year in the amount of $12,000.00.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) On January 11, 1937, the Board of Directors of the corporation authorized the issuance of debenture bonds to be designated "20 Year 8% Income Debentures" of a total par value of $250,000.00. The action of the Board of Directors was approved by the stockholders of the corporation at a meeting held on the same date.

(b) Prior to July 1, 1937, the corporation issued $150,000.00 par value of the "20 Year 8% Income Debentures", of which $114,648.00 par value was issued in exchange for 1,124 shares of the corporation's outstanding preferred stock, and $35,352.00 par value was issued for cash.

(c) During the period July 1, 1937 to December 31, 1937, the corporation had outstanding debentures of a par value of $150,000.00 on which interest accrued at the rate of 8% per annum. The amount of interest which accrued on these debentures during the last six months of 1937 was $6,000.00, and this amount was set up on the books of the corporation as accrued interest payable; the amount was paid and was claimed as a deduction in computing the taxable net income of the corporation for the calendar year 1937.

(d) During the calendar year 1938, the corporation had outstanding debentures of a par value of $150,000.00, on which interest accrued at the rate of 8% per annum. The amount of interest which accrued on these debentures during the calendar year 1938 was $12,000.00, and this amount was set up on the books of the corporation as accrued interest payable; the amount was paid and was claimed as a deduction in computing the taxable net income of the corporation for the calendar year 1938.

5 (e) During the calendar year 1939, the corporation had outstanding debentures of a par value of $150,000.00, on which interest accrued at the rate of 8% per annum. The amount of interest which accrued on these debentures during the calendar year 1939 was $12,000.00, and this amount was set up on the books of the corporation as accrued interest payable; the amount was paid and was claimed as a deduction in computing the taxable net income of the corporation for the calendar year 1939.

(f) During the years 1937, 1938, and 1939 the petitioner made sales on the installment plan, and, in respect to such sales, kept its books and reported income on the installment basis. In all other respects, the petitioner's books were kept and its income reported on the accrual basis.

Wherefore, the petitioner prays that this Board may hear the proceeding and determine that—

(a) The amount of $6,000.00 for the calendar year 1937 was an interest payment on bonds outstanding and was deductible in computing the taxable net income for the calendar year 1937, and there is no deficiency for the calendar year 1937.

(b) The amount of $12,000.00 for the calendar year 1938 was an interest payment on bonds outstanding and was deductible in computing the taxable net income for the calendar year 1938, and there is no deficiency for the calendar year 1938.

(c) The amount of $12,000.00 for the calendar year 1939 was an interest payment on bonds outstanding and was deductible in computing the taxable net income for the calendar year 1939, and there is no deficiency for the calendar year 1939.

E. H. Davis,
Counsel for Petitioner,
7 So. Dearborn Street,
Chicago, Illinois.

6 State of Illinois } ss.
County of Cook }

Roy F. Kelley, being duly sworn, says that he is the Secretary-Treasurer of The John Kelley Company, petitioner named above, and is duly authorized to verify the foregoing petition; that he has read the foregoing petition, or had the same read to him, and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those he believes to be true.

Roy F. Kelley,
Roy F. Kelley.

Subscribed and sworn to before me, a Notary Public, this the 4th day of November, 1941.

Ruth Stephens,
(Seal) *Notary Public.*

My commission expires January 8, 1944.

7 EXHIBIT "A".

TREASURY DEPARTMENT
Internal Revenue Service
Indianapolis, Indiana
August 11, 1941

The John Kelley Company
Second and Washington Streets
Marion, Indiana

Gentlemen:

You are advised that the determination of your income tax liability for the taxable years 1937, 1938 and 1939 disclosed a deficiency of $4,529.06 and that the determination

of your excess-profits tax liability for the years mentioned discloses a deficiency of $360.00, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Indianapolis, Ind. for the attention of ..... The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

Guy T. Helvering,
Commissioner,

By (Signed) Robert E. Wilson,
Acting Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.
EX/ter

8 Statement.

The John Kelley Company
Second and Washington Streets
Marion, Indiana
Tax Liability for the Taxable Years ended December 31, 1937, December 31, 1938 and December 31, 1939

Income Tax

Year	Liability	Assessed	Deficiency
1937	$18,826.08	$18,257.02	$ 569.06
1938	11,052.06	9,072.06	1,980.00
1939	13,624.37	11,644.37	1,980.00
Total	$43,502.51	$38,973.45	$4,529.06

Excess-Profits Tax

1937	$ 691.29	$ 331.29	$ 360.00
Total	$ 691.29	$ 331.29	$ 360.00

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the report of examination dated October 7, 1940, to your protest dated November 22, 1940 and to the statements made at the conferences held on February 4, 1941 and August 7, 1941.

A copy of this letter and statement has been mailed to your representative, Mr. J. M. Tackett, 7 Dearborn Street, Chicago, Illinois, in accordance with the authority contained in the power of attorney executed by you and on file with this office.

9 The John Kelley Company
Marion, Indiana

Adjustments to Net Income

1937

Net income as disclosed by return		$110,665.33
Unallowable deductions and additional income:		
(a) Reorganization expense	$ 606.50	
(b) Interest on debentures	6,000.00	
		6,606.50
Net income adjusted		$117,271.83

Explanation of Adjustments

(a) The item of reorganization expense in the amount of $606.50 is held to be a capital expenditure not deductible from income in accordance with Section 24 of the Revenue Act of 1936 and Article 24-2, Regulations 94.

(b) The item of interest paid on debentures in the amount of $6,000.00 is held to represent dividends not deductible from income in accordance with Section 23 of the Revenue Act of 1936.

Computation of Tax

Corporation

1937

Value of capital stock as declared in the capital stock tax return for the year ended 6/30/37		$1,011,822.98
Net income for excess-profits tax computation		$ 117,271.83
Less: Dividends received credit		4,568.07
Balance of net income		$ 112,703.76
Less: 10% of capital stock declared value		101,182.30
Net income subject to excess-profits tax		$ 11,521.46
Amount taxable at 6 percent		$ 11,521.46
Excess-profits tax at 6 percent		$ 691.29
Total excess-profits tax		$ 691.29
10 Amount forwarded		$ 691.29
Excess-profits tax previously assessed:		
Account No. 403501	$290.87	
Account No. 5-52022	40.42	
		331.29
Deficiency of excess-profits tax		$ 360.00
Income Tax Computation:		
Net income		$ 117,271.83
Less: Excess-profits tax	$ 691.29	
Dividend received credit	4,568.07	
Interest on obligations of U. S.	1,737.50	
		6,996.86
Normal net income		$ 110,274.97

Tax on portion of income not in excess of $2,000.00	$ 2,000.00	8%	$	160.00
Tax on portion of income in excess of $2,000.00 and not in excess of $15,000.00	13,000.00	11%		1,430.00
Tax on portion of income in excess of $15,000.00 and not in excess of $40,000.00	25,000.00	13%		3,250.00
Tax on portion of income in excess of $40,000.00	70,274.97	15%		10,541.25
Total normal tax			$	15,381.25
Surtax on Undistributed Profits:				
Net income			$	117,271.83
Less: Normal tax	$15,381.25			
Excess-profits tax	691.29			
Interest on obligations of United States	1,737.50			17,810.04
Adjusted net income			$	99,461.79
Less: Dividends paid credit				70,422.00
Undistributed net income			$	29,039.79
Balance forwarded			$	29,039.79
Less: Specific credit allowable				—0—
Remainder subject to surtax			$	29,039.79
Tax on $9,946.18 at 7%	$ 696.23			
Tax on $9,946.18 at 12%	1,193.54			
Tax on $9,147.43 at 17%	1,555.06			
Amount of tax			$	3,444.83
Total Normal Tax and Surtax			$	18,826.08
Normal tax previously assessed:				
Account No. 403501	$18,097.52			
Additional normal tax assessed:				
Account No. 5-52022	159.50			
				18,257.02
Deficiency in normal tax			$	569.06

Adjustments to Net Income

1938

Net income as disclosed by return		$ 55,441.01
Unallowable deductions and additional income		
(a) Interest	$12,000.00	
		12,000.00
Net income adjusted		$ 67,441.01

Explanation of Adjustments

(a) The item of interest paid on debentures in the amount of $12,000.00 is held to represent dividends not deductible from income in accordance with Section 23 of the Revenue Act of 1938.

12 Computation of Tax

Corporation

Value of capital stock as declared in the capital stock tax return for year ended 6/30/38	$1,250,000.00
Net income for excess-profits tax computation	$ 67,441.01
Less: Dividends received credit	2,490.25
Balance of net income	$ 64,950.76
Less: 10 percent of capital stock declared value	125,000.00
Net income subject to excess-profits tax	None
Excess-profits tax previously assessed: Account No. 400254	None
Deficiency in excess-profits tax	None
Tax on Corporations in General	
Net income for excess-profits tax computation	$ 67,441.01
Less: Excess-profits tax	None
Net income	$ 67,441.01
Less: Interest on obligations of the United States, etc.	3,341.50

Adjusted net income		$ 64,099.51
Tentative tax at 19 percent		$ 12,178.91
Less: 14.025 percent of credit for dividends received	$410.89	
2½ percent of the dividends paid credit (not to exceed 2½ percent of adjusted net income)	715.96	
		1,126.85
Total Income Tax		$ 11,052.06
Less: Tax previously assessed: Account No. 400254		9,072.06
Deficiency in income tax		$ 1,980.00

13 Adjustments to Net Income

1939

Net income as disclosed by return	$ 73,096.39
Unallowable deductions and additional income:	
(a) Interest on debentures	12,000.00
Net income adjusted	$ 85,096.39

Explanation of Adjustments

This item of interest paid on debentures in the amount of $12,000.00 is held to represent dividends not deductible from income in accordance with Section 23 of the Revenue Act of 1938.

Computation of Tax
Corporation

Excess-profits tax computation:		
Value of capital stock as declared in the capital stock tax return for year ended 6/30/39		$1,285,461.01
Net income for excess-profits tax computation		$ 85,096.39
Less: Dividends received credit		2,534.53
Balance of net income		$ 82,561.86
Less: 10 percent of capital stock declared value		128,546.10
Net income subject to excess-profits tax		None
Excess-profits tax previously assessed:		
Account No. 400210		None
Deficiency in excess-profits tax		None
14 Tax on Corporations in General:		
Net income for excess-profits tax computation		$ 85,096.39
Less: Excess-profits tax		None
Net income		$ 85,096.39
Less: Interest on obligations of the United States, etc.		1,226.48
Adjusted net income		$ 83,869.91
Tentative tax at 19 percent		$ 15,935.28
Less: 14.025 percent of credit for dividends received	$ 418.20	
2½ percent of the dividends paid credit (not to exceed 2½ percent of adjusted net income	1,892.71	
		2,310.91
Total tax under General Rule		$ 13,624.37
Total Income Tax		$ 13,624.37
Less:		
Tax Previously Assessed:		
Account No. 400210		11,644.37
Deficiency in tax		$ 1,980.00

15 UNITED STATES BOARD OF TAX APPEALS.

(Caption—109088)

AMENDED ANSWER.

(Filed May 18, 1942.)

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for amended answer to the petition filed by the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the taxes in controversy are income and excess-profits taxes for the year 1937 and income taxes for the calendar years 1938 and 1939, but denies that the amounts in controversy are as alleged in paragraph 3 of the petition.

4 (a), (b) and (c) Denies that the Commissioner erred as alleged in subparagraphs (a), (b) and (c) of paragraph 4 of the petition.

16 5. (a) and (b) Denies the allegations of fact contained in subparagraphs (a) and (b) of paragraph 5 of the petition.

(c) Denies the allegations contained in subparagraph (c) of paragraph 5 of the petition, except that it is admitted that $6,000.00 was set up on the books of the corporation as accrued interest payable, and claimed as a deduction in computing taxable net income of the corporation for the calendar year 1937.

(d) Denies the allegations contained in subparagraph (d) of paragraph 5 of the petition, except that it is admitted that $12,000.00 was set up on the books of the corporation as accrued interest payable, and claimed as a deduction in computing taxable net income of the corporation for the calendar year 1938.

(e) Denies the allegations contained in subparagraph (e) of paragraph 5 of the petition, except that it is admitted that $12,000.00 was set up on the books of the corporation as accrued interest payable, and claimed as a deduction in computing taxable net income of the corporation for the calendar year 1939.

(f) Denies the allegations contained in subparagraph

(f) of paragraph 5 of the petition, except that it is admitted that the petitioner's books are kept and its income reported on the accrual basis.

17 6. Denies generally and specifically each and every allegation contained in the petition not hereinbefore admitted, qualified or denied.

7. Further answering the petition the respondent avers (a) that in his final notice of deficiency the Commissioner, in computing the surtax on undistributed profits, has increased the dividend paid credit claimed in the returns for the years 1937, 1938 and 1939 in the amounts of $6,000.00, $12,000.00 and $12,000.00, respectively; (b) that these adjustments were brought about by reason of the Commissioner's action in determining that said amounts claimed as interest was in effect distributions of dividends; and (c) that in the event the Board should hold that said amounts or some part thereof constituted interest, the dividend paid credit as to each of the years 1937, 1938 and 1939 should be reduced by a corresponding amount.

Wherefore, respondent prays that the Board redetermine the deficiencies herein to be the amounts determined by the Commissioner; viz: $569.06 in income tax and $360.00 in excess-profits tax for the year 1937; $1,980.00 in income tax for the year 1938; and $1,980.00 in income tax for the year 1939.

(Signed) J. P. Wenchel,
F. R. S.
J. P. Wenchel,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
F. R. Shearer,
Division Counsel.
John D. Kiley,
Special Attorney,
Bureau of Internal Revenue.

18 EXCERPT FROM TRANSCRIPT OF HEARING AT INDIANAPOLIS, INDIANA, ON MAY 18, 1942, CONSISTING OF LINES 9, PAGE 33, TO AND INCLUDING LINE 24, PAGE 34.

By Mr. Albus:

Q. Mr. Kelly, we have read into the record certain book entries regarding the manner in which these bonds were

entered on your books at various times, some indicating making reference to stocks and others making reference to income debentures. Do you have any explanation for those differences?

A. We had a great deal of trouble with our book system in 1937. We had three different bookkeepers during that year. One of them, evidently, put it down stock and the rest just seemed to copy it and call it anything they wanted.

Mr. Kiley: That calls for a conclusion of the witness. I move it be stricken as not being responsive. The reason, that is a supposition, the reason that motivated these people to do that is purely speculative. He don't know why they did it.

The Member: How many bookkeepers did you say you had?

The Witness: Three.

The Member: Did you ever give them instructions about it?

The Witness: I never gave them any instructions about it, no sir. I never told them anything about it.

The Member: The motion will be granted.

By Mr. Albus:

Q. Mr. Kelly, when was the first time you knew there were any discrepancies in your books in this regard?

A. In the fall of 1940, when Mr. Hiller, the Internal Revenue man called my attention to it.

Mr. Albus: That is all Your Honor.

The Member: Any question, Mr. Kiley?

Mr. Kiley: Just a couple.

Cross-Examination by Mr. Kiley.

Q. In 1937 and 1938 and 1939, if I understood your testimony correctly, you were secretary and treasurer of the company?

A. Yes.

Q. And you had charge of the books and records—they were your responsibility were they?

A. Yes.

20 THE TAX COURT OF THE UNITED STATES.

(Caption—109088)

STIPULATION.

(Filed Dec. 5, 1942.)

Exhibit F attached to the Stipulation in the above case is a typewritten copy of the trust indenture under which the debentures involved in the case were issued. In said Exhibit F there is set forth the text of the debentures to be issued under the trust instrument. In the preparation of this document there occurred a typographical error with the result that a part of the first paragraph of the text of the indenture was omitted. It is hereby stipulated and agreed that the first paragraph of the text of the trust indenture appearing in Exhibit F should read as follows:

"The John Kelley Company, an Indiana corporation, for value received promises to pay to the
21 bearer on the 31st day of December, 1956, the sum of ..... Dollars ($.....) in lawful money of the United States of America at the office of the company in Marion, Indiana and to pay interest thereon in like lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this debenture for endorsement of payment thereon, conditioned however, upon the net income of the Company being sufficient during any interest period to pay the amount due as interest, in accord with the terms and provisions hereof. The interest on this income debenture shall not be cumulative."

The aforesaid correction causes the text of the debentures as set forth in the trust indenture to conform to the printed form of the debenture which constitutes Exhibit E of the stipulation.

Frank J. Albus,
Attorney for Petitioner.
(Signed) J. P. Wenchel,
OWS
Attorney for Respondent.

22 EXHIBIT "E".

UNITED STATES OF AMERICA

Form of Debenture

No. 89 $1,000.00

The John Kelley Company

20 Year 8% Income Debenture

The John Kelley Company, an Indiana corporation, for value received, promises to pay to the bearer on the 31st day of December, 1956, the sum of

One Thousand Dollars ($1,000)

in lawful money of the United States of America at the office of the Company in Marion, Indiana, and to pay interest thereon in like lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this Debenture for endorsement of payment thereon, conditioned, however, upon the net income of the Company being sufficient during any interest period to pay the mount due as interest, in accord with the terms and provisions hereof. The interest on this Income Debenture shall not be cumulative.

This debenture bond is one of an authorized issued of debentures of the Company in the aggregate principal amount of Two Hundred, Fifty Thousand Dollars ($250,000.00) all of like tenor and effect, known as its "20 Year 8% Income Debentures" of various denominations; all of which are issued, received and held subject to all the terms and conditions, and entitled to all the benefits specified in a trust agreement dated January 1, 1937, made by and between The John Kelley Company and Mabel K. Ronald and Roy F. Kelley, as Trustees, to which trust agreement reference is hereby made for a description of the rights of the holders of such debentures, and of the Trustees with respect to the enforcement thereof.

This debenture may be redeemed at the option of the Company on any interest date prior to maturity upon notice in the manner and upon the terms provided in the trust agreement by payment of its principal amount and accrued interest to the date of redemption; after such re-

demption date, interest on the debentures called for redemption shall cease unless payment thereof shall be refused after presentation. All debentures purchased or redeemed by the Trustees shall be cancelled and not reissued.

If any of the events of default specified in the trust agreement shall occur, all debentures outstanding hereunder may be declared to be due and payable in the manner and with the effect provided in the trust agreement.

In the payment of their claims, all creditors, other than the stockholders of the Company, shall rank superior to the holders of this income debenture, but all holders of this income debenture shall rank pari passu with each other and superior to the stockholders of the corporation with respect to their share stock.

This debenture shall not be valid or become obligatory for any purpose unless and until the certificate endorsed hereon shall have been executed by the Trustees under said trust agreement.

In Witness Whereof, The John Kelley Company has caused this debenture to be signed by its President or Vice-President, and its corporate seal to be hereunto affixed and attested by its Secretary or an Assistant Secretary as of the first day of January, 1937.

The John Kelley Company

By .....

President.

Attest:

.....

Secretary.

(U. S. Revenue Stamps required by law have been affixed and duly cancelled.)

23 Trustee's Certificate

This is one of the 20 Year Income Debentures described in the within mentioned Trust Agreement.

.....

Mabel K. Rotald

.....

Roy F. Kelley

Trustees

UNITED STATES OF AMERICA

No. 89

The John Kelley
Company
20 Year 8% Income
Debenture
$1000.00
Principal Payable
December 31, 1956

Interest Payable Annually On
December 31st

Principal Payable at
The Office of the Company
Marion, Indiana

24 EXHIBIT "F".

Trust Indenture.

This Trust Indenture made as of the 1st day of January, 1937 by and between The John Kelley Company, a corporation duly organized and existing under and by virtue of the laws of the State of Indiana, (hereinafter occasionally referred to as the "Company") party of the first part, and Mabel K. Ronald and Roy F. Kelley, as Trustees, (hereinafter occasionally referred to as the "Trustees"),

Witnesseth:

Whereas, the Company pursuant to a plan of reorganization and recapitalization has determined to issue Twenty Year 8% Income Debentures, in substantially the form and terms hereinafter specified, of the aggregate principal amount of Two Hundred, Fifty Thousand Dollars, ($250,000.00), said Debentures to be issued in various denominations; and

Whereas, all acts and proceedings necessary and required by law to make said debentures, when executed by the Company and authenticated by the Trustees, as in this Indenture provided, valid, binding and legal negotiable obligations of the Company, and to constitute this indenture a valid and effective agreement, have been done and taken, and the execution, issue and delivery of this indenture have in all respects been duly authorized by the Directors and Shareholders of the Company in full conformity to law; and

Whereas, the text of all the debentures to be issued hereunder and the Trustees' certificate to be endorsed upon the debentures are to be in substantially the following forms, respectively, viz.:

UNITED STATES OF AMERICA.

No. ..... $.....

The John Kelley Company

20 Year 8% Income Debentures.

The John Kelley Company, an Indiana corporation, for value received promises to pay to the bearer on the 31st day of December, 1956, the sum of .....

..... Dollars ($.....) in lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this debenture for endorsement of payment thereon, conditioned, however, upon the net income of the Company being sufficient during any interest period to pay the amount due as interest, in accord with the terms and provisions hereof. The interest on this income debenture shall not be cumulative.

This debenture bond is one of an authoried issue of debentures of the Company in the aggregate principal amount of Two Hundred, Fifty Thousand Dollars ($250,000.00) all of like tenor and effect, known as its "20 year 8% Income Debentures" of various denominations; all of which are issued, received and held subject to all the terms and conditions, and entitled to all the benefits specified in a trust agreement dated January 1, 1937, made by and between The John Kelley Company and Mabel K. Ronald and Roy F. Kelley, as Trustees, to which trust agreement reference is hereby made for a description of the rights of the holders.

of such debentures, and of the Trustees with respect to the enforcement thereof.

This debenture may be redeemed at the option of the Company on any interest date prior to maturity upon notice in the manner and upon the terms provided in the trust agreement by payment of its principal amount and accrued interest to the date of redemption; after such redemption date, interest on the debentures called for redemption shall cease unless payment thereof shall be refused after presentation. All debentures purchased or redeemed by the Trustees shall be cancelled and not reissued.

If any of the events of default specified in the trust agreement shall occur, all debentures outstanding hereunder may be declared to be due and payable in the manner and with the effect provided in the trust agreement.

In the payment of their claims, all creditors, other than the stockholders of the Company, shall rank superior to the holders of this income debenture, but all holders of this income debenture shall rank pari passu with each other and superior to the stockholders of the corporation with respect to their share stock.

This debenture shall not be valid or become obligatory for any purpose unless and until the certificate endorsed hereon shall have been executed by the Trustees under said trust agreement.

In Witness Whereof, The John Kelley Company has caused this debenture to be signed by its president or vice-president and its corporate seal to be hereunto affixed and attested by its secretary or an assistant secretary as of the first day of January, 1937.

The John Kelley Company,

By .....

President.

Attest:

.....

Secretary.

(U. S. Revenue Stamps required by law have been affixed and duly cancelled.)

Trustees' Certificate.

This is one of the 20 Year Income Debentures described in the within mentioned trust agreement.

Mabel K. Ronald,

Roy F. Kelley,
Trustees.

and, Whereas, the execution and issue of said debentures in said amount of Two Hundred, Fifty Thousand Dollars ($250,000.00) and the execution and delivery of this Trust Agreement have been in all respects duly authorized:

Now, Therefore, This Trust Agreement Witnesseth:

That to declare the terms and conditions upon which said debentures are to be authenticated and delivered by the Trustees and in consideration of the premises and of the purchase and acceptance of said debentures by the holders thereof and of the covenants herein contained, the
26 Company covenants and agrees with the Trustees, for the equal benefit of all present and future holders of said debentures, or any of them, as follows:

Article I.

Execution and Issue of Debentures.

Section 1. The debentures shall be executed and issued in the name and on behalf of the Company, signed by its President or a Vice-president with the corporate seal of the Company affixed thereto, attested by its secretary or an assistant secretary. They shall be payable to bearer. The debentures and Trustees certificates shall be substantially of the tenor and purport hereinbefore set forth.

Immediately upon the execution and delivery of this Trust Agreement the Company shall execute and deliver to the Trustees Two Hundred Fifty Thousand Dollars ($250,000.00) in aggregate principal amount of the said debentures. These debentures shall thereupon be authenticated by the Trustee, who shall sign the certificate provided therefor, and no debenture shall be valid or become obligatory for any purpose or be entitled to any right or benefit under this Trust Agreement until it shall have been authenticated. The debenture when so authenticated shall be delivered in

accordance with the orders of the Company, evidenced by a writing or writings, signed by its president or vice-president and its secretary or an assistant secretary. The total aggregate principal amount of debentures which may be executed by the Company and authenticated by the Trustees is limited to Two Hundred, Fifty Thousand Dollars ($250,000.00) except that further debentures may be executed, authenticated and delivered to replace debentures which have been mutilated, destroyed or lost, as herein provided.

Article II.

Covenants of the Company.

Section 1. The Company covenants that it will promptly pay or cause to be paid to every holder of any debenture issued hereunder the principal and interest accruing thereon in lawful money of the United States of America, on the dates and at the place and in the manner mentioned in said debentures. The interest on the debentures shall be payable only upon presentation thereof for endorsement thereon.

The Company covenants to pay to the Trustees sufficient funds to pay principal and interest five (5) business days before maturity thereof.

Section 2. The Company covenants that there are no liens or encumbrances on its real or personal property, and that so long as any of the debentures issued hereunder are outstanding the Company will not mortgage, pledge, or otherwise encumber any of its real or personal property owned at the date hereof or hereafter acquired.

Section 3. The Company covenants that so long as any of the debentures issued hereunder are outstanding, it will at all times keep all its buildings, plants, equipment, merchandise and fixtures and other insurable property properly insured against loss or damage by fire to the extent that such property is usually insured by companies operating retail stores and properties of a similar character.

27 Section 4. The Company covenants that so long as any of the debentures issued hereunder are outstanding it will pay to the holders thereof the full amount of interest stipulated to be paid therein before it shall declare a dividend to the holders of the common stock of the Company.

Article III.

Redemption of Debentures.

Section 1. The Company shall have the right to call, pay and redeem, on any interest day, all or any of said debentures at the principal amounts thereof and accrued interest. If less than all of the said debentures are called, then the debentures so called shall be drawn by lot in such manner as may be determined by the Company.

Section 2. Notice of the time and place of payment shall be mailed or delivered to the known holders and if less than all of said debentures are so called, the numbers and denominations of the debentures so called shall be stated in such notice.

Debentures called for redemption shall be payable at the office of the Trustees. The Company shall deposit with the Trustees not less than five days before the redemption date, cash sufficient to pay and redeem all debentures so called.

On the redemption date fixed in said notice the rights of the holders of said debentures, except to receive the redemption price, and accrued interest to said date, shall, cease and said debentures shall be surrendered before payment.

Article IV.

Default and Remedies.

Section 1. If one or more of the following events of default happen, viz.: (a) if default be made in the punctual payment of any installment of interest on any outstanding debenture or debentures or (b) if default be made in the observance or performance of any of the terms of said debentures or of this Trust Agreement, and any such last named default shall continue for a period of two (2) years after written notice thereof shall have been given to the Company by the Trustees (whose duty it shall be to give such notice at the request in writing of at least twenty-five per cent (25%) in principal amount of the debentures at the time outstanding hereunder), then and in every such case, the Trustees may, and upon the written request of the holders of twenty-five per cent (25%) in principal amount of the debentures then outstanding hereunder shall declare the principal of all debentures then outstanding here-

under to be due and payable immediately, and upon any such declaration the same shall become immediately due and payable, anything in this Trust Agreement or in said debentures contained to the contrary notwithstanding.

This provision, however, is subject to the conditions that if at any time after the principal of said debentures shall have been so declared due and payable, and before any judgment or decree for the payment of monies due shall have been entered, all arrears of interest upon all the debentures shall have been duly paid and all defaults shall have been made good, and all the stipulations of said debentures and of this Trust Agreement shall have been fully performed by the Company, then, and in every such case, the holders of a majority in principal amount of the debentures then outstanding, by written notice to the
28 Company and to the Trustees, may waive such default and its consequence and rescind such declaration; but no such waiver or rescission shall extend to or affect any subsequent default or impair any right consequent thereon.

Section 2. The company covenants that (a) in case default shall be made in the punctual payment of any installment of interest on any outstanding debenture or debentures and such default shall have continued for a period of two (2) years; or (b) in case default shall be made in the payment of the principal of any such debenture or debentures when the same shall become payable, whether upon maturity or upon call or declaration as provided in this Trust Agreement, then upon demand of the Trustees the Company will pay to the Trustees for the benefit of the holders of the debentures issued hereunder and then outstanding, the whole amount which then shall have become due and payable on all such debentures then outstanding and in addition thereto such further amount as shall be sufficient to cover the costs and expenses of collection, including a reasonable compensation to the Trustees, their agents, attorneys and counsel, and any expenses or liability incurred by the Trustees hereunder. In case the Company shall fail forthwith to pay such amount on such demand, the Trustees in their own names and as Trustees of an express trust shall be entitled and empowered to institute such action or proceeding at law or in equity, as may be advised by counsel, for the collection of the sums so due and unpaid and may prosecute any such action or proceeding to judgment or final decree and may enforce any such judgment or decree in the manner provided by law.

Section 3. All rights of action under this Trust Agreement or under any of said debentures may be enforced by the Trustees without the possession of any of the debentures or the production thereof on any trial or other proceedings instituted by the Trustees may be brought in their names as Trustees and any recovery of judgment shall be for the ratable benefit of the holders of said debentures.

Upon the written request of the holders of 25% in principal amount of the debentures at the time outstanding and upon being indemnified to its satisfaction for any liability which they may incur, it shall be the duty of the Trustees to take all necessary or proper steps for the protection and enforcement of their rights and the rights of the holders of the debentures, whether by judicial proceedings or otherwise as the Trustees being advised by counsel shall deem most expedient in the interest of the holders of the debentures

In the event of the violation or threatened violation by the Company of any of the prohibitions or negative covenants of this Trust Agreement, the Trustees may, and upon the written request of the holders of 10% in principal amount of the debentures outstanding and upon being indemnified to its satisfaction for any liability which they might incur, shall immediately take such action by suit in equity or at law, or otherwise, as they may be advised by counsel, to prevent or redress such violation.

The holders of a majority in amount of the debentures from time to time outstanding hereunder shall have the right by instrument in writing delivered to the Trustees to direct the method and place of conducting any proceedings to be taken hereunder for the enforcement of this Trust Agreement or of said debentures.

Section 4. Any monies collected by the Trustees shall be applied as follows, at the date fixed by the Trustees for the distribution of such monies, upon presentation of several debentures, and stamping thereon the payment if only partially paid and upon the surrender thereof, if fully paid:

First: To the payment of costs and expenses of the Trustees including reasonable compensation to themselves, their agents, attorneys and counsel.

Second: In case the principal of the income debentures shall not have become due, to the payment of the interest in default in the order of the maturity of the installments

of such interest with interest on the overdue installments at the rate of four per cent (4%) per annum; such payments to be made ratably to the persons entitled thereto without discrimination or preference.

Third: In case the principal of the debentures shall have become due by declaration or otherwise, to the payment of the whole amount then owing or unpaid upon the outstanding debentures for principal and interest with interest at the rate of four per cent (4%) per annum on the overdue principal and installments of interest; in case such money shall be insufficient to pay the same in full, then to the payment of such principal and interest without preference or priority of principal over interest, or of interest over principal, or of any installment of interest over any other installment of interest, ratably to the aggregate of such principal and accrued and unpaid interest.

Section 5. No holder of any income debenture issued hereunder shall have the right to institute any action or proceeding in equity or at law upon said debenture or debentures, or for the enforcement of any of the terms of this Trust Agreement, unless and until such holder shall have previously given to the Trustees written notice of a default of the Company in the performance of one or more of the stipulations of said debentures or of this Trust Agreement and its continuance as hereinbefore provided, and also unless or until the holders of twenty-five per cent (25%) (or in case of the prohibitions or negative covenants hereof, the holders of 10% as hereinabove provided) in principal amount of the debentures outstanding shall have made written request of the Trustees and shall have offered to said Trustees indemnity to their satisfaction against the costs, expenses and liabilities to be incurred by said Trustees, and shall have afforded to the Trustees a reasonable opportunity to exercise the powers herein granted to enforce this Trust Agreement, and the Trustees shall have refused or unreasonably delayed to comply with such request.

Provided, however, that nothing in this Trust Agreement shall affect or impair the obligation of the Company, which is unconditional and absolute, to pay at the date of maturity therein expressed the principal of the debentures to the respective holders thereof, or affect or impair the right of action of such holders to enforce such payment, subject only to the prior right of the Trustees, if exercised

promptly in accordance with the terms of this Trust Agreement.

Section 6. All remedies specifically conferred on the Trustees under this Trust Agreement shall be deemed cumulative and not exclusive and no delay or omission of the Trustees or of any holders of any of the debentures to exercise any right or power accruing upon any default shall impair any such right or power or be construed as a waiver of any such default or any acquiescence therein.

Article V.

Power to Amend Trust Agreement.

The Company and the Trustees may, from time to time, and at any time, enter into such agreements supplemental hereto, or amendatory hereof as shall be deemed by them necessary or desirable for the purpose of curing any ambiguity or of curing, correcting or supplementing any defective or inconsistent provisions contained herein or in any supplemental agreement, or for any other purpose not substantially inconsistent with the purposes of this agreement.

Article VI.

The Trustees.

The Trustees shall have no responsibility as to the validity of said debentures of the Company or as to their execution, and shall be held only to the exercise of reasonable care and diligence in carrying out the provisions of this Trust Agreement. The Trustees, may advise with counsel of their own selection (who may be counsel for the Company) and in taking any action or refraining therefrom under such advice shall incur no liability. For the current duties to be performed by the Trustees hereunder they shall receive such reasonable compensation as shall be agreed upon between them and the Company. In the event of any claim or probably default hereunder the Trustees shall be entitled, in addition, to be reimbursed by the Company for all proper outlays of whatever sort or nature to be incurred in or about this trust, in protecting the rights of the debenture holders, including counsel fees, and to receive from the Company a reasonable compensation for any duties that they may at any time perform in the dis-

charge of the same. All such fees, compensations and disbursements shall also constitute a first lien on all sums in its hands hereunder. They shall be entitled in the case of such claimed or probably default to advice of counsel in all matters concerning the trust. The Trustees may treat any holder of any debenture as the owner thereof, but shall not be bound to do so nor to take any action at his request unless the ownership thereof shall be otherwise shown to their satisfaction. The Trustees shall be under no obligation or duty to take any proceedings for the purpose of enforcing said debentures of this Trust Agreement unless they shall be reasonably indemnified against any liability in respect thereof, nor shall it be any part of the Trustee's duties to keep themselves advised or informed as to the performance of any of the Company's covenants or of any suit at law or in equity which the Trustees may institute against the Company in consequence of any such default; but the Trustees shall have the right to take whatever action to them may seem advisable to enforce said debentures of this Trust Agreement for the protection of the holders of all of said Debentures. The Trustees shall have the right to acquire and own debentures of this issue with the same rights which they would have were they not Trustees.

The Trustees, or any Trustee hereafter appointed may resign the Trust hereby created upon giving ninety (90) days notice in writing to the Company by mail, or such shorter notice as the Company may accept. The Trustees may be removed at an time by an instrument in writing signed by the holders of a majority in principal amount of the debentures then outstanding, and filed with such Trustees, subject to the right of the Trustees to receive reasonable compensation for the services and reimbursement of their costs and expenses. In the event of the resignation or removal of the Trustees, their successor may be designated by an instrument in writing signed by the holders of a majority in principal amount of the debentures then outstanding, or in the event that such designation be not made by the debenture holders within a period of ninety (90) days from the date of the resignation or removal, a successor Trustee may be named by the Company.

31 Any new Trustee appointed hereunder shall execute, acknowledge and deliver to the Trustee last in office and also to the Company, an instrument in writing accept-

ing such appointment hereunder, and shall thereupon become invested without further act or writing with all the rights, powers, trusts, duties and obligations of the Trustee hereunder with like effect as if originally named as Trustee hereunder.

Should any instrument in writing from the Company or from the Trustees last in office be required by any new Trustee or Trustees for more fully and certainly vesting in and confirming to such new Trustee such rights, powers and duties, any and all such instruments in writing shall on request be made, executed, acknowledged and delivered.

Article VII.

Successors and Assigns.

For every purpose of this Trust Agreement the terms, "The Company" includes and means The John Kelley Company and also its successors and assigns, including any corporation with or into which it may be consolidated or merged, or to which it may sell its properties as an entirety for the purpose of reincorporation. The word "Trustees" shall mean the Trustees for the time being, whether original or successor.

Mabel K. Ronald and Roy F. Kelley accept the trusts by this Trust Agreement declared and provided and agree to perform the same upon the terms and conditions herein set forth.

In Witness Whereof, The John Kelley Company has caused this instrument to be executed and acknowledged by its President or a Vice-President and its corporate seal to be hereunto affixed, attested by the signature of its Secretary or an Assistant-Secretary, and Mabel K. Ronald and Roy F. Kelley have caused this instrument to be executed and acknowledged by them.

The John Kelley Company,
By (Signed) Mabel K. Ronald,
President.

(Corporate Seal)

Attest:
(Signed) Roy F. Kelley,
Secretary.

(Signed) Mabel K. Ronald,
(Signed) Roy F. Kelley,
Trustees.

32 EXHIBIT "G".

No. 49 ..... Shares

Incorporated under the laws of the State of Indiana
Non-assessable

The John Kelley Company
Marion, Indiana

Capital Stock $450,000.00

Common Stock $150,000.00
Shares $100.00 Par Value

Preferred Stock $300,000.00
Shares $100.00 Par Value

This Certifies That .....
is the owner of ..... fully paid and non-assessable shares, of the par value of One Hundred ($100.00) Dollars each, of the Preferred Capital Stock of The John Kelley Company, transferable in person, or by attorney, upon surrender of this Certificate properly endorsed.

The Preferred Stock of this Corporation shall have as against the Common Stock a first lien on the assets of the Corporation, subject, however, to the rights of creditors, and shall be entitled each year out of the surplus and net profits of the Corporation to a fixed dividend of six (6%) per cent, payable semi-annually on the first days of January and July, and before any dividends shall be set apart or paid on the Common Stock. The dividends on the Preferred Stock shall be cumulative so that, if for any year dividends amounting to six per cent shall not be paid on the Preferred Stock, the deficiency shall be a charge upon the net earnings of the Corporation and be paid subsequently before any dividend shall be set apart or paid upon the Common Stock; after which, the remaining surplus and profits shall belong to the Common Stock. In the event of liquidation of the Corporation, the assets shall first be applied in liquidation of claims of creditors, then of the Preferred Stock at par and six (6%) per cent cumulative annual dividends, after which, the remaining assets shall be distributed to the holders of the Common Stock. The Preferred Stock, or any part thereof, may be redeemed or retired, at the option of the Company, at any semi-annual dividend paying period, at the price of $102.00 per share, together with the unpaid dividends thereon, if any, by giving to the holder or holders thereof, a notice in

writing thirty (30) days in advance of said dividend paying period, of the Company's exercise of said option to redeem, and, thereafter, such Preferred Stock shall cease to be entitled to dividends upon tender of said redemption price and accrued dividends. The Preferred Stock shall be at all times entitled to all of the rights and subject to all of the restrictions provided by the laws of the State of Indiana relating to Preferred Stock.

In Witness Whereof, the said Corporation has caused this Certificate to be signed by its President, its Secretary, and its Treasurer and its Corporate Seal to be hereunto affixed, this ..... day of ....., 19.....

.....
(Seal) *President.*
Attest:

.....
Secretary.

.....
Treasurer.

Shares 100 Each

33 Certificate
for

.....

Shares
of the
Preferred
Stock
The John Kelley Co.
Marion, Indiana
Issued To

.....

Date

.....

For Value Received, ... hereby sell, assign and transfer unto .....

..... Shares of the Preferred Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint ..... Attorney to transfer the said Stock on the books of the within named

Corporation with full power of substitution in the premises.

Dated ..... 19.....

In presence of .....

(In right-hand margin) Notice: The signature of this assignment must correspond with the name as written upon the face of the Certificate, in every particular, without alteration or enlargement, or any change whatever.

34 THE TAX COURT OF THE UNITED STATES.

(Filed Jan. 15, 1943.)

John Kelley Company, Petitioner, *vs.* Commissioner of Internal Revenue, Respondent.

Docket No. 109088. Promulgated January 15, 1943

Petitioner in 1937 issued "20 year 8% income debentures," having a maturity date, bearing interest to be paid out of earnings and not cumulative, subordinate to the claims of all creditors, superior to the rights of stockholders, subject to certain procedure for collection in event of designated defaults as specified in the trust agreement, and holders having no right to participate in management of corporation. Part of the "debentures" was issued on subscription and the balance was issued in exchange for all of petitioner's outstanding preferred stock, which was retired. *Held*, payments made to debenture holders are deductible as interest.

Frank J. Albus, Esq., for the petitioner.

John D. Kiley, Esq., for the respondent.

The respondent has determined against petitioner income tax deficiencies for the calendar years 1937, 1938, and 1939 in the amounts of $569.06, $1,980, and $1,980, respectively, and an excess profits tax deficiency in the amount of $360 for 1937.

The only issue presented is whether the payments on corporate debentures were interest on indebtedness or dividends on stock.

Findings of Fact.

Substantially all the facts are stipulated and are hereby found accordingly. Those facts hereafter appearing which

are not from the stipulation are facts found from the record made at the hearing.

Petitioner is an Indiana corporation, organized in 1907 and reorganized in 1930, and has its principal place of business in Marion, Indiana. It is engaged in a retail furniture business. Its income tax returns for the calendar years 1937, 1938, and 1939 were prepared from books kept on the accrual basis, the taxable profit on installment sales being computed on the installment basis, and were filed with the collector of internal revenue at Indianapolis, Indiana.

On January 1, 1937, the petitioner had authorized as capital stock 1,500 shares of common stock at no par value and 3,000 shares of preferred stock at $100 par value, of which 1,110 shares of common stock and 1,124 shares of preferred stock had been issued and were outstanding. Roy F. Kelley, individually, owned 567 shares of common stock
35 and 628 shares of preferred stock, and, as trustee for Mabel K. Ronald, he owned 543 shares of common stock and 496 shares of preferred stock. Mabel K. Ronald, who died May 30, 1940, was a sister of Roy F. Kelley.

During the month of January 1937 Roy F. Kelley transferred the 628 shares of preferred stock and 171 of the common shares owned by him in his own right; 50 shares of preferred to Mabel K. Ronald, as trustee for her daughters, Ruth Stevens Korper and Mary Louise Stogsdill; 289 shares of preferred to Mabel K. Ronald as trustee for Ruth Stevens Korper; 289 shares of preferred to Mabel K. Ronald as trustee for Mary Louise Stogsdill; and the 171 shares of common stock to his wife, Birdena Kelley. It was provided in the above three trusts, however, that Birdena Kelley should receive the income from the 628 shares of preferred stock during her lifetime.

On January 11, 1937, a special meeting of the board of directors of the petitioner corporation was held and a plan of recapitalization was adopted. Following that meeting and on the same date the shareholders of the corporation held a special meeting and approved the resolution adopted by the board of directors. Under this resolution the authorized issue of 1,500 shares of common stock of no par value was changed to 4,500 shares of common stock with a par value of $100 per share and then increased to 6,000 shares. The resolution also authorized the issue of "income debenture bonds" aggregating the sum of $250,000,

bearing interest at the rate of 8 per cent per annum, and the execution of a trust agreement setting forth the terms and conditions upon which said debenture bonds were issued and the power and duties of the trustees. Under the resolution the income debenture bonds would be offered by the trustees in exchange for the issued and outstanding 1,124 shares of the preferred stock on the basis of $102 in face value of debentures for each share of said preferred stock; and, for the purpose of raising additional capital to expand the business of the corporation "in the field of finance", the trustees were to offer any and all unissued debenture bonds for sale at face value to the shareholders of the corporation. The directors meeting was attended by the three directors, Mabel K. Ronald, Roy F. Kelley, and Mary Louise Stogsdill, and the holders of the entire capital stock of the corporation, Mabel K. Ronald and Roy F. Kelley, were present at the meeting of the shareholders.

The trust indenture dated January 1, 1937, was entered into by the petitioner corporation through its president, Mabel K. Ronald, and secretary, Roy F. Kelley, with the trustees, Mabel K. Ronald and Roy F. Kelley. None of the income debenture bonds were issued prior to July 1, 1937. On that date Roy F. Kelley, as trustee for Mabel K. Ronald, delivered to the petitioner 496 shares of pre-
36 ferred stock, and coincidental therewith there wer delivered to Roy F. Kelley, as trustee for Mabe K. Ronald, $50,592 face amount of the said bonds. On he same date, Mabel K. Ronald, as trustee for Ruth Stev ns Korper and Mary Louise Stogsdill, delivered to the petitioner 628 shares of preferred stock, and coincidental therewith there were delivered to Mabel K. Ronald, as trustee for the same beneficiaries, $64,056 face amount of the income debenture bonds. On July 1, 1937, Mabel K. Ronald and Birdena Kelley subscribed for $24,408 and $10,944, respectively, of the said bonds. These amounts were carried against them in open accounts on the books of the petitioner and were later wiped out by the credit of dividends received by them on common stock. In the case of Mabel K. Ronald the dividends so credited were on the common stock held for her by Roy F. Kelley, as trustee, while in the case of Birdena Kelley the said dividends were on the 171 shares of common stock which had been transferred to her by Roy F. Kelley in January of 1937.

Petitioner, on December 10, 1937, filed articles of amend-

ment of its articles of incorporation with the Secretary of State of Indiana, which showed the total number of shares of its capital stock to be 3,000 shares of preferred stock having a par value of $100 each and 6,000 shares of common stock having a par value of $100 each.

On December 15, 1937, 1,110 outstanding shares of common stock of the petitioner were owned, 396 shares by Roy F. Kelley; 171 shares by Birdena Kelley; and 543 shares by Roy F. Kelley, as trustee for Mabel K. Ronald. A cash dividend of $55 per share was paid on 1,110 shares on December 15, 1937, after which a common stock dividend of 3½ shares for each share of common stock held was declared and paid by petitioner.

During the periods of July 1 to December 31, 1937; January 1 to December 30, 1938; and January 1 to December 31, 1939, the petitioner had outstanding "income debenture bonds" of the face amount of $150,000, in respect of which $6,000, $12,000, and $12,000 for each period, respectively, were set up on the books of petitioner as accrued interest thereon. The amounts so accrued were paid and were claimed by petitioner as deductions in computing its taxable net income for the respective calendar year 1937, 1938, and 1939. These deductions were disallowed by the respondent.

On the petitioner's books the "income debentures" were referred to as "stocks," "bonds," and "notes." Charges were entered in an account which was headed "accrued interest, income debentures." The petitioner in its capital stock tax returns for 1938 and 1939 listed "debenture" and "debenture notes," respectively, as capital stock. They were not reflected as indebtedness in the balance sheets appearing in the income and excess profits tax returns filed by petitioner for 1937, 1938, and 1939, but
37 appear under the heading "Capital Stock: Debenture Notes." The board of directors annually adopted corporate resolutions authorizing the payment of "interest" on the "income debenture bonds" or "debenture notes." On most of the checks, drawn for the "interest" on the "income debentures" to the holders thereof, the nature of payment was described to be for "Interest, income debenture stock."

On January 1, 1937, the assets of petitioner totaled $963,807.57 and its liabilities exclusive of common and preferred stock totaled $75,817.74. On December 31, 1937, its total

assets were $982,221.08 and its total liabilities exclusive of common stock and the debentures were $46,158.19.

The trust indenture set out the form of debenture to be issued, which was substantially followed, and the debentures in controversy, in so far as material, read as follows:

> THE JOHN KELLEY COMPANY, an Indiana corporation, for value received, promises to pay to the bearer on the 31st day of December, 1956, the sum of ONE THOUSAND DOLLARS ($1,000) in lawful money of the United States of America at the office of the Company in Marion, Indiana, and to pay interest thereon in like lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this Debenture for endorsement of payment thereon, conditioned, however, upon the net income of the Company being sufficient during any interest period to pay the amount due as interest, in accord with the terms and provisions hereof. The interest on this Income Debenture shall not be cumulative.
>
> * * * * * * *
>
> If any of the events of default specified in the trust agreement shall occur, all debentures outstanding hereunder may be declared to be due and payable in the manner and with the effect provided in the trust agreement.
>
> In the payment of their claims, all creditors, other than the stockholders of the Company, shall rank superior to the holders of this income debenture, but all holders of this income debenture shall rank pari passu with each other and superior to the stockholders of the corporation with respect to their share stock.

Article IV of the trust indenture set forth "Default and Remedies," and the first two sections thereof designated "default" as follows:

> Section 1. If one or more of the following events of default happen, viz; (a) if default be made in the punctual payment of any installment of interest on any outstanding debenture or debentures or (b) if default be made in the observance or performance of any of the terms of said debentures or of this Trust Agreement, and any such last named default shall

continue for a period of two (2) years after written notice thereof shall have been given to the Company by the Trustees (whose duty it shall be to give such notice at the request in writing of at least twenty-five per cent (25%) in principal amount of the debentures at the time outstanding hereunder), then and in every such case, the Trustees may, and upon the written request of the holders of twenty-five per cent (25%) in principal amount of the debentures then oustanding hereunder shall declare the principal of all debentures then outstanding hereunder to be due and payable immediately, and upon any such declaration the same shall become immediately due and payable, anything in this Trust Agreement or in said debentures contained to the contrary nothwithstanding.

This provision, however, is subject to the conditions that if at any time after the principal of said debentures shall have been so declared due and payable, and before any judgment or decree for the payment of monies due shall have been entered, all arrears of interest upon all the debentures shall have been duly paid and all defaults shall have been made good, and all the stipulations of said debentures and of this Trust Agreement shall have been fully performed by the Company, then, and in every such case, the holders of a majority in principal amount of the debentures then outstanding, by written notice to the Company and to the Trustees, may waive such default and its consequence and rescind such declaration; but no such waiver or rescission shall extend to or affect any subsequent default or impair any right consequent thereon.

Section 2. The company covenants that (a) in case default shall be made in the punctual payment of any installment of interest on any outstanding debenture or debentures and such default shall have continued for a period of two (2) years; or (b) in case default shall be made in the payment of the principal of any such debenture or debentures when the same shall become payable, whether upon maturity or upon call or declaration as provided in this Trust Agreement, then upon demand of the Trustees the Company will pay to the Trustees for the benefit of the holders of the debentures issued hereunder and then

outstanding, the whole amount which then shall have become due and payable on all such debentures then outstanding and in addition thereto such further amount as shall be sufficient to cover the costs and expenses of collection, including a reasonable compensation to the Trustees, their agents, attorneys and counsel, and any expenses or liability incurred by the Trustees hereunder. In case the Company shall fail forth-with to pay such amount on such demand, the Trustees in their own names and as Trustees of an express trust shall be entitled and empowered to institute such action or proceeding at law or in equity, as may be advised by counsel, for the collection of the sums so due and unpaid and may prosecute any such action or proceeding to judgment or final decree and may enforce any such judgment or decree in the manner provided by law.

The trust indenture provided certain procedure to be followed by the trustees and debenture holders in enforcing payment of the interest and principal, in case of default by the petitioner. In one provision the petitioner pledged that all of its property was free of mortgage and no lien or any other encumbrance would be placed upon it as long as any of the debentures were outstanding. It was also provided that the debentures were subordinate to the claims of petitioner's creditors but had priority over the claims of the stockholders. The holders of the debentures were not given the right to participate in the management of the business.

OPINION.

TURNER, *Judge:* If the debentures have created an indebtedness the payments to the holders thereof are interest and deductible as expense, but if they are in fact capital stock the payments are dividends and not deductible.

Similar questions have been before this tribunal and other courts, and with each one it was necessary to consider all of the facts and circumstances in the particular case in order to determine if the relationship was that of a stock ownership or of debtor and creditor. In some cases the determining characteristic has been one factor, while in other cases it has been another. No one factor is neces-

sarily controlling. *Commissioner* v. *Schmoll Fils, Associated, Inc.*, 110 Fed. (2d) 611 (C.C.A., 2d Cir., 1940).

The determining factors are usually listed as the name given to the certificates, the presence or absence of maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties. Applying the test of these determining characteristics, we conclude petitioner should prevail.

Though at different times the petitioner might have called the "debentures" "stock," at all times the payments thereon, whether on the books, in the minutes, or in the income tax returns, were referred to as "interest." It is true that the interest was to be paid out of "net income," but that in itself is not decisive. *H. R. DeMilt Co.*, 7 B. T. A. 7. In the event of default the trustees and debenture holders were entitled to declare, in a designated process, the debentures immediately due and payable and to institute suit thereon. The fact that the debentures were subordinated to the rights of all creditors but were prior to those of the stockholders is not of itself conclusive against their classification as indebtedness. *O. P. P. Holding Corporation*, 30 B. T. A. 337; affd., 76 Fed. (2d) 11 (C. C. A. 2d Cir.). The debenture holder did not have the right to participate in the management of the corporation. It is apparent that the holders of the preferred stock, in exchanging the stock for "20 year 8% income debentures," preferred the debtor-creditor status of debenture holders to that of stockholders, and stockholders have the right to change to the creditor-debtor basis, though the reason may be purely personal to the parties concerned. *Commissioner* v. *Procter Shop, Inc.*, 82 Fed. (2d) 702 (C. C. A., 9th Cir.), affirming 30 B. T. A. 721.

In computing the surtax on undistributed profits the respondent increased the dividend paid credit claimed by petitioner in the returns for the years 1937, 1938, and 1939 in the amounts of $6,000, $12,000, and $12,000, respectively, by reason of having determined the said amounts were dividends and not interest. The dividend paid credit as to each of the years should be reduced by a corresponding amount.

Decision will be entered under Rule 50.

40 THE TAX COURT OF THE UNITED STATES.

(Caption—109088)

DECISION.

(Entered Feb. 19, 1943.)

Pursuant to the findings of fact and opinion of the Court promulgated January 15, 1943, the respondent herein on February 2, 1943 filed a recomputation of tax, and on February 17, 1943 the petitioner filed an agreement to such recomputation. It is, therefore,

Ordered and Decided: That there are no deficiencies in income tax for the calendar years 1937, 1938 and 1939, and that there is no deficiency in excess-profits tax for said year 1937.

(Signed) Bolon B. Turner,
(Seal) *Judge.*

Entered Feb. 19, 1943.

41 IN THE UNITED STATES CIRCUIT COURT OF APPEALS

For the Seventh Circuit.

Guy T. Helvering, Commissioner of Internal Revenue,
Petitioner on Review,
vs.
The John Kelley Company,
Respondent on Review.
} B. T. A. No. 109088.

PETITION FOR REVIEW.

(Filed May 18, 1943.)

Guy T. Helvering, United States Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United Circuit Court of Appeals for the Seventh Circuit to review the decision entered by The Tax Court of the United States on February 19, 1943, whereby it is ordered and decided that there are no deficiencies in income tax for the calendar years 1937, 1938 and 1939, and that there is no deficiency in excess-profits tax for said year 1937. The taxpayer, The John Kelley Company, filed its corporation income and excess-profits tax returns for the calendar years 1937, 1938 and 1939 with

the Collector of Internal Revenue for the District of Indiana, whose office is located at Indianapolis, Indiana, and within the judicial circuit of the United States Circuit Court of Appeals for the Seventh Circuit. The Commissioner files this petition pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

(Sgd.) Samuel O. Clark, Jr.,
Assistant Attorney General.

(Signed) J. P. Wenchel,
RLW
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

JMM:sw 5-12-43

42 IN THE UNITED STATES CIRCUIT COURT OF APPEALS.

(Caption—109088)

STATEMENT OF POINTS.

(Filed May 18, 1943.)

Comes now Guy T. Helvering, Commissioner of Internal Revenue, the petitioner on review herein, by and through his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, and J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and hereby asserts the following errors which he intends to urge on review by the United States Circuit Court of Appeals for the Seventh Circuit of the decision of The Tax Court of the United States entered herein on February 19, 1943:

1. The Tax Court of the United States erred in holding that the amounts of $6,000, $12,000, and $12,000 for the respective taxable years 1937, 1938 and 1939, claimed as deductions by taxpayer as interest accrued and paid upon its so-called 20-year 8% income debentures, represented "interest paid or accrued within the taxable year on indebtedness" within the meaning of Section 23(b) of the Revenue Acts of 1936 and 1938, and are, therefore, allowable as deductions in the respective taxable years; and in overruling the action of the Commissioner in disallowing such deductions.

43 2. The Tax Court of the United States erred in failing to hold that the designated 20-year 8% debentures

represented proprietary interests rather than indebtedness and hence the so-called interest on the designated debentures is in reality a dividend which cannot be deducted in computing net income.

3. The Tax Court of the United States erred in holding that there are no deficiencies in income tax for the calendar years 1937, 1938 and 1939, and that there is no deficiency in excess-profits tax for said year 1937.

4. The Tax Court of the United States erred in failing to hold that there are deficiencies in income tax for the years 1937, 1938 and 1939 in the amounts of $596.06, $1,980, and $1,980, respectively, and that there is a deficiency in excess-profits tax in the amount of $360 for the year 1937.

5. The Tax Court of the United States erred in that its opinion and decision are not supported by the evidence and are contrary to law.

(Sgd.) Samuel O. Clark, Jr.,
Assistant Attorney General.

(Signed) J. P. Wenchel,
RLW
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

JMM:sw 5-12-43

44 IN THE UNITED STATES CIRCUIT COURT OF APPEALS.

(Caption—109088)

NOTICE OF FILING PETITION FOR REVIEW AND STATEMENT OF POINTS.

(Filed May 25, 1943.)

To: The John Kelley Company,
Second & Washington Streets,
Marion, Indiana,
Respondent on Review.

You are hereby notified that the Commissioner of Internal Revenue did, on the 18th day of May, 1943, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review and statement of points by the United States Circuit Court of Appeals for the Seventh Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition

for review and statement of points as filed is hereto attached and served upon you.

Dated this 18th day of May, 1943.

(Signed) J. P. Wenchel,
RLW
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and statement of points mentioned therein, is hereby acknowledged this 20th day of May, 1943.

The John Kelley Company,
By (Sgd.) Ray F. Kelley,
Treas.

JMM:sw 5-13-43

45 IN THE UNITED STATES CIRCUIT COURT OF APPEALS.

(Caption—109088)

NOTICE OF FILING PETITION FOR REVIEW AND STATEMENT OF POINTS.

(Filed May 18, 1943.)

The Tax Court of the United States. Filed May 21, 1943.

To: Frank J. Albus, Esquire,
Earle Building,
Washington, D. C.,
Counsel for Respondent on Review.

You are hereby notified that the Commissioner of Internal Revenue did, on the 18th day of May, 1943, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review and statement of points by the United States Circuit Court of Appeals for the Seventh Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review and statement of points as filed is hereto attached and served upon you.

Dated this 18th day of May, 1943.

(s) B. D. Gamble,
B. D. Gamble,
Clerk, The Tax Court of the United States.

Service of the above and foregoing notice, together with a copy of the petition for review and statement of points mentioned therein, is hereby acknowledged this 19th day of May, 1943.

(s) Frank J. Albus,
Counsel for Respondent on Review.

46 IN THE UNITED STATES CIRCUIT COURT OF APPEALS.

* * (Caption—109088) * *

DESIGNATION OF CONTENTS OF RECORD.

(Filed Sept. 17, 1943.)

To the Clerk of The Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Seventh Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries.
2. Pleadings:
(a) Petition.
(b) Amended answer.
3. Findings of fact and opinion and the decision of the Tax Court.
4. Petition for review and statement of points.
5. Notices of filing petition for review.
5(a). Excerpt from transcript of hearing at Indianapolis, Indiana, on May 18, 1942, consisting of lines 9, page 33, to and including line 24, page 34.

47 6. Exhibits E, F, and G, which are attached to stipulation of facts, and stipulation filed December 5, 1942.
7. This designation.

(Sgd.) Samuel O. Clark, Jr.,
SLY
Samuel O. Clark, Jr.,
Assistant Attorney General.

(Signed) J. P. Wenchel,
SLY
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.
Attorneys for Petitioner on Review.

Service of a copy of the within designation of contents of record is hereby admitted this 13th day of September, 1943.

(Sgd.) Frank J. Albus,
Attorney for Respondent on Review.

48 THE TAX COURT OF THE UNITED STATES.

* * (Caption—109088) * *

ORDER ENLARGING TIME.

(Entered June 23, 1943.)

Upon motion of counsel for petitioner, it is

Ordered that the time for preparation, transmission and delivery of the record sur petition for review of the above-entitled proceeding in the United States Circuit Court of Appeals for the Seventh Circuit is extended to August 16, 1943.

(Signed) J. E. Murdock,
(Seal) *Presiding Judge.*

Dated: Washington, D. C.,
June 23, 1943.

mhn

Now, Oct. 1, 1943 the foregoing order certified from the record as a true copy.

B. D. Gamble,
(Seal) *Clerk, The Tax Court of the United States.*

49 IN THE UNITED STATES CIRCUIT COURT OF APPEALS.

* * (Caption—109088) * *

ORDER.

(Filed Aug. 11, 1943.)

The Tax Court of the United States. Filed August 11, 1943.

For Cause Shown, It Is Ordered that the time within which to file the record on review in the above-entitled cause with this court be, and the same is, extended to and including Oct. 16, 1943.

It Is Further Ordered that the Clerk of this court is di-

rected to transmit to the Clerk of The Tax Court of the United States, a certified copy of this order.

Done at Chicago, Illinois, this 9th day of August, A. D. 1943.

William M. Sparks,
Judge, United States Circuit Court of Appeals for the Seventh Circuit.

Now, Oct. 1, 1943 the foregoing order certified from the record as a true copy.

B. D. Gamble,
(Seal) *Clerk, The Tax Court of the United States.*

50 UNITED STATES CIRCUIT COURT OF APPEALS

For the Seventh Circuit.

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do hereby certify that the foregoing typewritten pages contain a true copy of order entered this day in Cause No. B. T. A. 109088, Guy T. Helvering, Commissioner of Internal Revenue, Petitioner *vs.* The John Kelley Company, Respondent, as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In Testimony Whereof I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this ninth day of August, A. D. 1943.

(S) Kenneth J. Carrick,
(Seal) *Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.*

51 THE TAX COURT OF THE UNITED STATES

Washington.

Commissioner of Internal Revenue, *Petitioner*,
vs.
The John Kelley Company, *Respondent*.
} Docket No. 109088.

CERTIFICATE.

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 47, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 1st day of October, 1943.

B. D. Gamble,
Clerk, The Tax Court of the United States.

(Seal)

UNITED STATES CIRCUIT COURT OF APPEALS,

For the Seventh Circuit.

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do hereby certify thatt he foregoing printed pages contain a true copy of the printed record, printed under my supervision and filed on the ninth day of December, 1943, in:

Cause No. 8426.

Commissioner of Internal Revenue,
Petitioner,

vs.

The John Kelley Company,
Respondent,

as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In Testimony Whereof I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this 16th day of January, A. D. 1945.

(signed) Kenneth J. Carrick,
(Seal) *Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.*

At a regular term of the United States Circuit Court of Appeals for the Seventh Circuit, held in the City of Chicago, and begun on the twenty-eighth day of September, in the year of our Lord one thousand nine hundred and forty-three and of our Independence, the one hundred and sixty-eighth.

Commissioner of Internal Revenue, *Petitioner,* vs. The John Kelley Company, *Respondent.*	Petition for Review of Decision of the Tax Court of the United States.

8426

And, to-wit: On the eleventh day of October, 1943, there was filed in the office of the Clerk of this Court, an appearance of counsel for Respondent, which said appearance is in the words and figures following, to-wit:

UNITED STATES CIRCUIT COURT OF APPEALS,

For the Seventh Circuit.

Cause No. 8426.

Commissioner of Internal Revenue,
Petitioner,

vs.

The John Kelley Company,
Respondent.

The Clerk will enter my appearance as counsel for Respondent.

Frank J. Albus,
Earle Bldg.,
Wash., D. C. 4.

Endorsed: Filed October 11, 1943. Kenneth J. Carrick, Clerk.

And afterwards, to-wit: On the twenty-third day of December, 1943, there was filed in the office of the Clerk of this Court, an appearance for counsel for Petitioner, which said appearance is in the words and figures following, to-wit:

UNITED STATES CIRCUIT COURT OF APPEALS,

For the Seventh Circuit.

Case No. 8426.

Commissioner of Internal Revenue,
Petitioner,

vs.

The John Kelley Company,
Respondent.

The Clerk will enter our appearances as counsel for the Petitioner.

J. P. Wenchel, C.A.R.
Chief Counsel, Bureau of Internal Revenue.
John M. Morawski, C.A.R.
Special Attorney, Bureau of Internal Revenue.

Endorsed: Filed December 23, 1943. Kenneth J. Carrick, Clerk.

And afterwards, to-wit: On the third day of January, 1944, there was filed in the office of the Clerk of this Court, an appearance of counsel for Petitioner, which said appearance is in the words and figures following, to-wit:

UNITED STATES CIRCUIT COURT OF APPEALS.

For the Seventh Circuit.

Case No. 8426.

Commissioner of Internal Revenue,
Petitioner,

vs.

The John Kelley Company,
Respondent.

The Clerk will enter our appearances as counsel for the Petitioner.

Samuel O. Clark, Jr.,
Assistant Attorney General.

Sewall Key,
Robert N. Anderson,
Muriel Paul,
Special Assistants to the Attorney General.

Endorsed: Filed January 3, 1944. Kenneth J. Carrick, Clerk.

And afterwards, to-wit: On the fifteenth day of November, 1944, the following further proceedings were had and entered of record, to-wit:

Wednesday, November 15, 1944.

Court met pursuant to adjournment.

Before:

Hon. Evan A. Evans, Circuit Judge.
Hon. Otto Kerner, Circuit Judge.
Hon. Sherman Minton, Circuit Judge.

Commissioner of Internal Revenue, *Petitioner,* vs. The John Kelley Company, *Respondent.*	Petition for Review of Decision of the Tax Court of the United States.

8426

Now this day come the parties by their counsel, and this cause comes on to be heard on the transcript of the record and the briefs of counsel, and on oral argument by Miss Maryhelen Wigle, counsel for petitioner, and by Mr. Frank J. Albus, counsel for respondent, and the Court takes this matter under advisement.

And afterwards, to-wit: On the twenty-first day of December, 1944, there was filed in the office of the Clerk of this Court, the Opinion of the Court, which said opinion is in the words and figures following, to-wit:

IN THE UNITED STATES CIRCUIT COURT OF APPEALS,

For the Seventh Circuit.

No. 8426. OCTOBER TERM AND SESSION, 1944.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,* *vs.* THE JOHN KELLEY COMPANY, *Respondent.*	Petition for Review of Decision of the Tax Court of the United States.

December 21, 1944.

Before EVANS, KERNER, and MINTON, *Circuit Judges.*

MINTON, *Circuit Judge.* The Commissioner of Internal Revenue determined deficiencies in income and excess profits tax against the taxpayer, the John Kelley Company for the calendar years 1937, 1938, 1939. The Tax Court refused to sustain the assessment, and the Commissioner has petitioned for review. The alleged deficiencies arose from the taxpayer's deduction of payments made on income debentures as interest on indebtedness. The Commissioner contends that the payments were dividends within the meaning of section 115 (a) and not interest within the meaning of section 23 (b) of the Revenue Act of 1936, Chap. 690; 49 Stat. 1648; 26 U. S. C. A. §§ 23 (b) and 115 (a).

The sole question presented is whether the payments were interest. There is no dispute as to the facts, and the evidence in the record before us is documentary. Thus a question of law is presented, and its review is clearly authorized by statute. 44 Stat. 110; 26 U. S. C. A. § 1141 (c) (1). *Commissioner* v. *Meridian & Thirteenth Realty Co.*, 132 F. 2d 182, 188.

In deciding cases of this kind the various provisions of the instrument evidencing the obligation in the light of the surrounding circumstances in each case determine whether the relationship created is proprietary or that of debtor-creditor. Each case stands on its own feet. As we said in *Commissioner v. Meridian & Thirteenth Realty Co., supra* at p. 185:

> "Precedents are abundant, but because of the widely-varying fact bases upon which the conclusions are reached, they serve only as guides. Many are the criteria named to aid in the determination. Sometimes a particular one is called decisive,—or the most important test,—sometimes a combination of the elements sways the determination."

The following are the pertinent facts. The taxpayer is an Indiana corporation operating a retail furniture store. Its books were kept on an accrual basis. On January 1, 1937, taxpayer had authorized 1,500 shares of no par common stock and 3,000 shares of 6% cumulative preferred stock of $100 par value, of which 1,110 of the common and 1,124 of the preferred were outstanding. The business was a closely held family corporation. All the outstanding common stock was owned by Roy Kelley, his wife, and his sister, Mabel Kelley Ronald. The latter was president of the company, and Roy Kelley was secretary. The preferred stock was all owned either individually or as trustee by Roy Kelley and his sister.

On January 11, 1937, the corporation adopted resolutions authorizing a so-called plan of reorganization. Under this plan, the common stock was changed to $100 par value and increased to 6,000 shares. Twenty year "income debenture bonds" aggregating $250,000 and bearing interest at 8% per annum were authorized. At the same time, and as part of the same scheme, a trust agreement was executed, setting forth the terms upon which the debentures were issued and outlining the powers and duties of the trustee. The trust agreement was signed on behalf of the company by its president, Mabel K. Ronald, and by her brother, Roy Kelley, as secretary. Then they moved to the other side of the table and signed the agreement as trustees. It was all a little arrangement between them. The same people represented both sides of the transaction. This is enough to inspire hesitation in calling it a bona fide trust agreement.

Under the scheme the "income debentures" were exchanged for the preferred stock at $102 per share. Also, for the purpose of raising additional capital to expand the business "in the field of finance," as the resolution recited, the trustees were authorized to sell additional debentures at par, but *only* to the shareholders of the corporation. Mabel K. Ronald and Berdina Kelley, the wife of Roy Kelley, subscribed for $24,408 and $10,944, respectively, of the debentures. They did not pay cash for these debentures, but the subscriptions were charged to the purchasers on the books of the company and were later wiped out by the credit of dividends paid on the common stock held by each.

The dividends of this little corporation, even in these slack business years, were exceptionally good. A cash dividend of $55 per share and a stock dividend of 3½ shares for one was paid on the common stock in 1937. Attention is called to the fact that Mabel K. Ronald who, as a trustee, was obligated to promote the sale of the debentures in order to raise additional capital to expand the business, herself bought some debentures without paying cash for them. Such a transaction did not put a penny of new money into the treasury of the corporation. It may further be observed that in a slack business year such as 1937 a corporation which was able to pay $55 a share cash dividends and a stock dividend of 3½ shares for one, ought not to have had to pay 8% interest on its debentures. In our opinion, the 8% rate of interest was not fixed with any regard to the money market in 1937 but was fixed to drain off 8% interest on debentures which had retired 6% stock.

The 8% interest on the debentures was payable *only* out of the *net income* of the company. If there was no income, there were no payments, and *defaulted payments did not accumulate*. At liquidation or insolvency, the debenture holders were superior in rank only to the common stockholders, just as were the former preferred stockholders. All other creditors had preference. The preference of the debenture holders over the stockholders meant nothing, because all the debentures were held by stockholders, either individually or as trustees. The debenture holders had no voice in management. That, too, was of little moment, for the same reason.

On the books of the company the income debentures were referred to variously as "stocks," "bonds," and "notes."

In the capital stock tax returns for 1938 and 1939, the "debentures" and "debenture notes" were listed as capital stock. They were not reflected as indebtedness in the balance sheets appearing in the income and excess profits tax returns filed by the respondent for 1937, 1938, and 1939, but appeared under the heading, "Capital Stock: Debenture Notes." On most of the checks drawn to make the income payments on the debentures, the nature of the payment was described as "Interest, income debenture stock."

While the name given to the document is not controlling[1] it may be persuasive, if consistently used, as indicative of the intent and purpose of the corporation issuing the document. On the other hand, if there has been inconsistent use of such names, it may be considered in determining whether the corporation did what it professed to do.

In 1937, $6,000 was paid as income on the debentures and $12,000 was paid in each of the years 1938 and 1939. The taxpayer deducted these payments as interest on indebtedness pursuant to section 23 (b).

From this statement of the facts, it becomes apparent that these debentures had every aspect of preferred stock except one: they had a definite maturity date. It is not, however, unusual today for preferred stock to have a maturity or retirement date. In fact, such is authorized by Indiana corporation law. Burns Ind. Stat. Anno. (1933) § 25-205. *Commissioner* v. *Meridian & Thirteenth Realty Co., supra* at p. 186, note 6. The presence of a maturity date, however, is not controlling. *Kentucky River Coal Corp.* v. *Lucas*, 51 F. 2d 586, 588, aff. 63 F. 2d 1007. Especially is this true where, as in the case at bar, debentures were unsecured and were inferior to the claims of any creditor.

The scheme to convert the preferred stock into debentures left the debentures resembling preferred stock rather than indebtedness. "In the business world 'interest on indebtedness' means compensation for the use or forebearance of money." *Deputy* v. *du Pont*, 308 U. S. 488, 498, 60 S. Ct. 363, 84 L. Ed. 416. The taxpayer "hired" no money here. Its owners merely swapped papers and wound up in relatively the same position.

1. "Law of Federal Income Taxes," Merten, §26.10; *Commissioner* v. *Schmoll Fils Associated, Inc.*, 110 F. 2d 611, 613; *Jewel Tea Co., Inc.* v. *United States*, 90 F. 2d 451, 452.

Stockholders take the risks of a business while creditors must be paid whether the corporation has a net income or not. The distinguishing feature of one is risk, and of the other, security. In the case at bar, the debenture owners were not to be paid in any event but were to be paid only after all other creditors were paid; and the "interest" on the debentures was to be paid only if sufficient net income was earned within the period. Such debentures obviously evidenced risk capital, not creditor capital. In short, it was all a matter of accounting hocus-pocus, guided by a little too clever legal planning which eventuated in a rather flimsy scheme to avoid paying of taxes. As far as we are concerned, it will not succeed.

No case has been decided where the facts so clearly characterized the document as stock. A consideration of cases in the Circuit Courts of Appeals and the District Courts discloses none where noncumulative payments, payable out of earnings only, have been held to be interest.[2] Every provision of these debentures is a frequent and authorized clause familiar to preferred stock. Viewing this transaction from any angle, it has all the aspects of an issue of restricted preferred stock. In our opinion, payments made on the so-called "debentures" were dividends within the meaning of section 115 (a) and not interest on indebtedness.

The judgment of the Tax Court is

REVERSED.

Endorsed: Filed December 21, 1944. Kenneth J. Carrick, Clerk.

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2. *Helvering* v. *Richmond, F. & P. R. Co.*, 90 F. 2d 371; *Commissioner* v. *Palmer, Stacy-Merrill, Inc.* 111 F. 2d 809; *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833; *Commissioner* v. *O. P. P. Holding Corporation*, 76 F. 2d, 11; *Commissioner* v. *H. P. Hood & Sons, Inc.*, 141 F. 2d 467; *Commissioner* v. *J. N. Bray Co.*, 126 F. 2d 612; *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792; *United States* v. *Title Guarantee & Trust Co.*, 133 F. 2d 990; *Diamond Calk Horse Shoe Co.* v. *United States*, 40-2 USTC ¶ 9641, app. dism'd. 116 F. 2d 284. The only holding to the contrary is a Tax Court memorandum decision, *S. Glaser & Sons, Inc.* v. *Commissioner*, CCH Dec. 14,006 (M).

And on the same day, to-wit: On the twenty-first day of December, 1944, the following further proceedings were had and entered of record, to-wit:

Thursday, December 21, 1944.

Court met pursuant to adjournment.

Before:

Hon. Evan A. Evans, Circuit Judge.
Hon. Otto Kerner, Circuit Judge.
Hon. Sherman Minton, Circuit Judge.

Commissioner of Internal Revenue, *Petitioner,* vs. The John Kelley Company, *Respondent.*	Petition for Review of Decision of the Tax Court of the United States.
8426	

This cause came on to be heard of the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on February 19, 1943, be, and the same is hereby, reversed, and that this cause be, and it is hereby, remanded to the said Tax Court of the United States.

UNITED STATES CIRCUIT COURT OF APPEALS,

For the Seventh Circuit.

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do hereby certify that the foregoing printed pages contain a true copy of proceedings had and papers filed, excepting briefs of counsel, motions and orders extending time for filing briefs and motions relative to argument of the case, in:

Cause No. 8426.

Commissioner of Internal Revenue,
Petitioner,

vs.

The John Kelley Company,
Respondent,

as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In Testimony Whereof I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this 16th day of January, A. D. 1945.

(signed) Kenneth J. Carrick,
(Seal) *Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.*

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed April 30, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit is granted; and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

FRANK J. ALBUS,
Counsel for Petitioner.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

To the Honorable the Supreme Court of the United States, Your Petitioner Respectfully Shows:

Summary Statement of the Matter Involved

The Petitioner is an Indiana Corporation, with its principal place of business at Marion, Indiana (R. 34). On January 1, 1937 the Petitioner had outstanding 1,124 shares of preferred stock of a par value of $100.00 per share (R. 34). Roy F. Kelley individually owned 628 shares of the preferred stock, and he held the balance of 496 shares as Trustee for his sister, Mabel K. Ronald (R. 34). During the month of January, 1937, Roy F. Kelley transferred his 628 shares of preferred stock to Mabel K. Ronald, to be held by her as Trustee for the benefit of her daughters, with a

life interest in Berdina Kelley, the wife of Roy F. Kelley (R. 34).

During the month of January, 1937 a special meeting of the Board of Directors of the Petitioner Corporation was held, and a plan of recapitalization was adopted (R. 34). Following this meeting, and on the same date, the shareholders of the Petitioner Corporation held a special meeting and approved the resolution adopted by the Board of Directors (R. 34). This resolution authorized the issuance of income debenture bonds, aggregating the sum of $250,000, bearing interest at the rate of 8% per annum, and authorized the execution of a trust instrument, setting forth the terms and conditions under which the debenture bonds were to be issued, and setting forth the powers and duties of the Trustees (R. 34 and 35). Under the resolution, the bonds were to be offered by the Trustees in exchange for the outstanding 1,124 shares of preferred stock on the basis of $102.00 in face value of bonds for each share of preferred stock, and for the purpose of raising additional capital to expand the business of the Petitioner in the field of finance, the Trustees were to offer any and all unissued debenture bonds for sale at face value to the shareholders of the corporation (R. 35).

The trust agreement was entered into, and on July 1, 1937 the holders of the 1,124 shares of preferred stock surrendered their stock to the corporation and received bonds in the face amount of $114,648. On the same date, Mabel K. Ronald subscribed for $24,408 of the bonds and Berdina Kelley subscribed for $10,944 of the bonds. These amounts were carried against Mabel K. Ronald and Berdina Kelley in open accounts on the books of the Petitioner Corporation, and the liability was later satisfied by the credit of dividends received by them on common stock which they owned (R. 35).

During the period from July 1 to December 31, 1937; January 1 to December 31, 1938; and January 1 to December 31, 1939, the Petitioner had outstanding bonds of a face amount of $150,000, in respect of which $6,000, $12,000 and $12,000 for each period, respectively, were set up on the books of the Petitioner Corporation as accrued interest thereon. The amounts so accrued were paid and were claimed by the Petitioner as deductions in computing its taxable net income for the respective calendar years 1937, 1938 and 1939. These deductions were disallowed by the Respondent on the theory that the payments represented dividends on stock and not interest on indebtedness (R. 36 and R. 8, Par. (b)). The Tax Court of the United States reversed the action taken by the Respondent, and held that the debentures were bonds, with the result that the amounts paid in connection therewith were interest payments which the Petitioner was entitled to deduct in arriving at net income (R. 33, et seq.).

The Commissioner of Internal Revenue appealed the decision of the Tax Court to the Circuit Court of Appeals for the 7th Circuit. That Court reversed the decision of the Tax Court on the basis of its own finding of fact that the issuance of the bonds was not bona fide, which finding is diametrically opposed to the finding of fact made by the Tax Court. The Circuit Court based its conclusion upon its finding of fact that "it was all a matter of accounting hocus-pocus, guided by a little too clever legal planning which eventuated in a rather flimsy scheme to avoid payment of taxes" (R. 59). This finding of fact upon which the entire determination of the Circuit Court rests, is the direct opposite of the finding made by the Tax Court, namely, that the transaction was bona fide, and that as a result thereof, the bondholders became creditors of the Petitioner Corporation (R. 40).

This Court Has Jurisdiction

This Court is expressly given jurisdiction by Section 240 of the Judicial Code, as amended by Act of February 13, 1925 (43 Stat. 938; 28 U. S. C. Sec. 347) to review by certiorari the decision of the Circuit Court of Appeals, "either before or after a judgment or decree by such lower Court." Judgment was entered in this case by the U. S. Circuit Court of Appeals for the 7th Circuit on December 21, 1944 (R. 60).

Statute Involved

Section 23 of the Revenue Act of 1936 (c. 690, Section 23, 49 Stat. 1658); Section 23 of the Revenue Act of 1938 (c. 289, Section 23, 52 Stat. 460); and Section 23 of the Internal Revenue Code (53 Stat. 12, as amended June 29, 1939, c. 247, Title II, Sections 211 (a), 224, 53 Stat. 867, 880) all provide:

"Section 23. Deductions from gross income.

In computing net income there shall be allowed as deductions:

(b) Interest. All interest paid or accrued within the taxable year on indebtedness." * * * (Balance of Section not applicable).

Questions Presented

The following questions are presented:

(1) Did the U. S. Circuit Court of Appeals for the Seventh Circuit have the right to reverse the decision of the Tax Court on the basis of a fact finding made by the Circuit Court, which finding is diametrically opposed to the finding made by the Tax Court?

(2) Were the debentures issued by the Petitioner on July 1, 1937 bonds, with the result that the payments made

in connection therewith were interest within the provisions of Section 23(b) of the Internal Revenue Code, (53 Stat. 867, 880; Title 26, U. S. C., Section 23 (b)), and identical provisions of the Revenue Acts of 1936 and 1938, or were they stock, with the result that the payments made in connection therewith were dividends within the provisions of Section 115 of the Internal Revenue Code, (53 Stat. 46, as amended by 53 Stat. 873; Title 26 U. S. C., Section 115) and similar provisions of the Revenue Acts of 1936 and 1938?

Reasons Relied Upon for Allowance of the Writ

The decision of the Circuit Court of Appeals for the 7th Circuit is in direct conflict with the decisions of this Court in the cases of *Dobson* v. *Commissioner of Internal Revenue*, 320 U. S. 489 and *Scottish American Investment Company, Ltd.* v. *Commissioner of Internal Revenue*, 323 U. S. 119, which decisions held that a Circuit Court of Appeals cannot reverse a decision of the Tax Court on the basis of fact findings contrary to the facts found by the Tax Court (Supreme Court Rule 38, Paragraph 5 (b)).

The decision of the Circuit Court of Appeals for the 7th Circuit is in conflict with the decisions of that Court in the cases of *Geo. F. Fox* v. *Harrison*, 145 Fed. (2d) 521 and *Superior Coal Company* v. *Commissioner*, 145 Fed. (2d) 597, in which cases the 7th Circuit Court held that they had no right to reverse a fact finding of the trial court. (Supreme Court Rule 38, Paragraph 5 (b)).

The decision of the Circuit Court of Appeals for the 7th Circuit is in conflict with the decision of the Circuit Court of Appeals for the First Circuit in the case of H. P. Hood & Sons, Inc., 114 Fed. (2d) 467, which case involved substantially the same facts found in the case of the Petitioner. (Supreme Court Rule 38, Paragraph 5 (b)).

Wherefore, your Petitioner prays that a writ of certiorari issue under the seal of this Court, directed to the U. S. Circuit Court of Appeals for the Seventh Circuit, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings of the said Circuit Court had in the case numbered and entitled on its docket, No. 8426, Commissioner of Internal Revenue, *Petitioner*, v. *The John Kelley Company*, Respondent, to the end that this cause may be reviewed and determined by this Court, as provided for by the Statutes of the United States; and that the judgment herein of said Circuit Court be reversed by this Court, and for such other relief as to this Court may seem proper.

THE JOHN KELLEY COMPANY,
By FRANK J. ALBUS,
Counsel for Petitioner.

Washington, D. C., February, 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Opinions of the Courts Below

The opinion of the Tax Court of the United States is reported in 1 T. C. 457, and is printed in full in the record at Pages 33 to 40, inclusive.

The opinion of the Circuit Court of Appeals for the Seventh Circuit is not yet officially reported, but is printed in full in the record at Pages 55 to 59, inclusive.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code (43 Stat. 938, 28 U. S. C. Section 347). The Circuit Court of Appeals has in this case rendered a decision in conflict with the decisions of this Court (Supreme Court Rule 38, (b) (5)).

Judgment was entered in this case by the Circuit Court of Appeals on December 21, 1944 (R. 60).

Statement of the Case

A statement of the case is set forth in the Petition For Writ of Certiorari.

Summary of Argument

The Petitioner is contending that the Circuit Court of Appeals clearly erred in not only ignoring an essential fact found by the Tax Court, but in actually basing its decision on a finding of fact made by it which is diametrically opposed to the finding made by the Tax Court. The Petitioner contends that this action on the part of the Circuit Court of Appeals is in direct conflict with the decisions of this Court in the cases of *Dobson* v. *Commissioner of Internal Revenue*, 320 U. S. 489, and *Scottish American Investment Company, Ltd.* v. *Commissioner*, 323 U. S. 119, as well as other Supreme Court cases cited in Footnote (22) in the Dobson case.

The Petitioner is further contending that from the standpoint of the merits, the decision of the Tax Court in holding that the instruments involved are bonds is correct, and that the decision of the Circuit Court of Appeals for the 7th Circuit in holding that the instruments are stock is in direct conflict with the decision of the Circuit Court of Appeals for the First Circuit in the case of *H. P. Hood & Sons, Inc.*, 141 Fed. (2d) 467.

ARGUMENT

Point 1

The decision of the Circuit Court of Appeals is clearly in conflict with the decisions of this Court in the cases of Dobson v. Commissioner of Internal Revenue, 320 U. S. 489, Scottish American Investment Company, Ltd., v. Commissioner, 323 U. S. 119, and similar cases cited in footnote (22) in the Dobson case.

Under date of December 20, 1943, this Court decided the case of *Dobson* v. *Commisisoner of Internal Revenue*, 320 U. S. 489, and set forth the circumstances under which a Circuit Court of Appeals may, and may not, reverse a decision of the Tax Court of the United States. In the Dobson case, this Court said:

> "The judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the Administrative body."

This Court further said:

> "When the Court cannot separate the elements of a decision, so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand."

The Circuit Court of Appeals for the 7th Circuit found no "clear-cut mistake of law" in the instant case. It merely refused to recognize a finding of fact made by the Tax Court, namely, that the issuance of the bonds was a bona fide transaction. It made its own finding of fact, namely, that the transaction was "all a matter of accounting hocus-pocus" (R. 59), which finding is the direct opposite of the finding made by the Tax Court. The decision of the Circuit Court of Appeals is based squarely on the aforesaid finding of fact made by it. Even before

the decision by this Court in the Dobson case, it was an established rule of appellate jurisprudence that an appellate court could not disturb the facts found by the trial court, unless there was no evidence to support the finding. There was abundant evidence before the Tax Court to support its finding that the issuance of the bonds was bona fide, and, therefore, the Circuit Court of Appeals for the 7th Circuit had no authority to reverse this finding.

In the Dobson case, this Court further said:

> "Where no Statute or Regulation controls, the Tax Court's selection of the course to be followed is no more reviewable than any other question of fact."
>
> * * * * * * * * *
>
> "The Statute gives no inkling as to the correctness or incorrectness of the Tax Court's view, and we can find no compelling reason to substitute our judgment."

The foregoing statements apply with compelling force in the distant case. There is absolutely nothing in the Internal Revenue Code that in any way aids in the solution of the problem as to whether an instrument is a bond or a preferred stock. Neither the word "bond", nor the word "stock", is defined in the Internal Revenue Code, and as far as the decision in this case is concerned, the Tax Court could have reached its conclusion without referring to the Internal Revenue Code. Consequently, this is the very type of case which this Court had in mind when it made the above statements in the Dobson case. The principle of the Dobson case has been cited and followed by every Circuit Court of Appeals, and as a matter of fact, it has been followed by the Circuit Court of Appeals for the 7th Circuit in the cases of *George F. Fox* v. *Harrison*, 145 Fed. (2d) 521, and *Superior Coal Company* v. *Commissioner*, 145 Fed. (2d) 597.

A case which more clearly establishes error on the part of the Circuit Court of Appeals in the instant case is that of *Scottish American Investment Company, Ltd.* v. *Commissioner*, 323 U. S. 119, decided by this Court on December 4, 1944, for the reason that the decision of the Tax Court in that case rested squarely on its finding of fact that a certain transaction was bona fide. The sole question in the case was whether an office maintained in the United States by three foreign corporations was a bona fide office or a sham. The Tax Court found as a fact that the office maintained by the taxpayers was a bona fide office, and it, therefore, decided the case in favor of the taxpayers. The Third Circuit reversed the Tax Court on the basis of its own finding of fact that the office maintained in the United States by the taxpayers was a sham. This Court reversed the Third Circuit, and held that that Court had no right to disturb the finding of the Tax Court. During the course of its opinion, this Court said:

> "The sole issue revolves about the propriety of *the inferences and conclusions* drawn from the evidence by the Tax Court." (Italics supplied.)
>
> . . . . . .
>
> "The Tax Court has the primary function of finding the facts in tax disputes, weighing the evidence, *and choosing from among conflicting factual inferences and conclusions* those which it considers most reasonable. *The Circuit Court of Appeals has no power to change or add to those findings of fact, or to re-weigh the evidence.*" (Italics supplied.)
>
> . . . . . .
>
> "The judicial eye must not in the first instance rove about, searching for evidence to support other conflicting inferences and conclusions which the judges or the litigants may consider more reasonable or desirable."
>
> . . . . . .

"We cannot say that it was unreasonable for the Tax Court to conclude that this office was more than a sham, and that it was used for the regular transaction of business."

* * * * * * *

"We do not decide or infer that the contrary inferences and conclusions urged by the Commissioner are entirely unreasonable or completely unsupported by any probative evidence. We merely hold *that such conditions are irrelevant;* so long as there is adequate support in the evidence for what the Tax Court has inferred. *It follows that the Tax Court's conclusions in this case cannot be set aside on appellate review.*" (Italics supplied.)

All of the foregoing language applies with compelling force to the action of the Circuit Court of Appeals in reversing the Tax Court in the instant case. The Court held a transaction to be a sham in the face of a contrary fact finding by the Tax Court that it was bona fide. This Court in the *Scottish American Investment Company, Ltd.* case said that this is clearly reversible error. The *Scottish American Investment Company Ltd.* case was decided by this Court seventeen days before the decision of the Circuit Court of Appeals in the instant case was released. The Circuit Court of Appeals did not even mention the *Scottish American Investment Company Ltd.* case, nor did it mention the *Dobson* case, although both of these cases were called to its attention before its opinion was released. The Circuit Court of Appeals cited as its authority for reversing the Tax Court, its own decision in the case of *Commissioner* v. *Meridian & Thirteenth Realty Company,* 132 Fed. (2d) 182, which was decided on November 5, 1942, long before this Court announced the applicable rule in the *Dobson* case.

The *Scottish American Investment Company Ltd.* case is also of major importance from another angle. In that case, this Court said that the general principle of the *Dobson* case applies with the greatest possible force, where the decision of the Tax Court is such that the particular case will be "of little value as precedent". In this connection, this Court said:

> "Moreover, this case exemplifies one type of factual dispute where judicial abstinence should be pronounced. The decision as to the facts in this case, like analogous ones that precede it, is of little value as precedent. The factual pattern is too decisive and too varied from case to case to warrant a great expenditure of appellate court energy on *unravelling conflicting inferences.* The skilled judgment of the Tax Court, which is the basic fact-finding and *inference-making body* should thus be given wide range in such proceedings." (Italics supplied.)

The Circuit Court of Appeals, by its own admission, recognized that the instant case is one falling squarely within the above category. At R. 56 the Circuit Court of Appeals said:

> "In deciding cases of this kind, the various provisions of the instrument evidencing the obligation in the light of the surrounding circumstances *in each case* determine whether the relationship created is proprietary or that of debtor-creditor. *Each case stands on its own feet.*" (Italics supplied.)

Regardless of the above statement, the Circuit Court of Appeals took it upon itself to reverse the Tax Court, in direct violation of the admonition set forth by this court in the *Scottish American Investment Company, Ltd.* case. In its opinion at R. 55, the Circuit Court said, "There is no dispute as to the facts," but regardless of this state-

ment, the Circuit Court then proceeded to reverse the keystone fact found by the Tax Court, namely, that the issuance of the bonds was bona fide and that the holders thereof became creditors of the Petitioner Corporation.

See also the case of *W. G. Choate* v. *Commissioner*, No. 93, decided by this Court on January 29, 1945 (not yet officially reported), and the many cases cited by this Court in Footnote (22) in the *Dobson* case.

POINT 2

The decision of the Court of Appeals in the instant case is contrary to its own decisions in the cases of George F. Fox v. Harrison, 145 Fed. (2d) 521 and Superior Coal Company v. Commissioner, 145 Fed. (2d) 597.

The Circuit Court of Appeals for the Seventh Circuit decided the case of *George F. Fox* v. *Harrison*, 145 Fed. (2d) 521, on November 18, 1944. The trial court found as a fact that the redemption of stock by a corporation was not accomplished at such time and in such manner as to make the redemption essentially equivalent to the distribution of a taxable dividend within the meaning of Section 115 (g) of the Internal Revenue Code. The taxpayer appealed the decision of the Trial Court to the Circuit Court of Appeals for the 7th Circuit. The Circuit Court of Appeals for the 7th Circuit, on the authority of the *Dobson* case, held that it was without power to reverse the decision of the lower court. It will be noted that in the *Fox* case, the Circuit Court of Appeals held on the authority of the *Dobson* case, that it could not reverse the decision of the trial court, which had held that the distribution was not a dividend within the meaning of Section 115 (g) of the Internal Revenue Code. In the instant case, the Tax Court found that the distributions were interest payments

and not dividends within Section 115 of the Internal Revenue Code, yet the Circuit Court of Appeals reversed the conclusion of the Tax Court, and held that the distributions were dividends within the meaning of that Section.

On December 7, 1944 the 7th Circuit decided the case of *Superior Coal Company* v. *Commissioner of Internal Revenue*, 145 Fed. (2d) 597. In that case, the Tax Court had found as a fact that certain real property had become worthless prior to the taxable year involved. The taxpayer appealed the decision of the Tax Court to the 7th Circuit, and that Court held, on the authority of the *Dobson* case, that it could not disturb the finding of the Tax Court.

Both of the above cases were decided by the Circuit Court of Appeals for the 7th Circuit before it released its decision in the instant case on December 21, 1944. The Circuit Court of Appeals did not mention the aforesaid cases in its opinion in the instant case, and it made no attempt whatever to show in what respects the instant case is distinguishable from the above-mentioned two cases.

POINT 3

On the basis of the merits, the decision of the Tax Court was correct.

The decision of the Circuit Court of Appeals in the instant case is in error when the case is considered solely from the standpoint of the merits of the case, and it is in conflict with the decision of the Circuit Court of Appeals for the First Circuit in the case of *Commissioner of Internal Revenue* v. *H. P. Hood & Sons, Inc.*, 141 Fed. (2d) 467.

The interest on the bonds in the instant case was payable only from income, and the rights of the bondholders were subordinate to the rights of general creditors (R 17).

The Circuit Court leaned heavily upon these provisions in the instrument in reaching its conclusion in the case. But the Tax Court took these matters into consideration in deciding the case in favor of the Petitioner, and it held that in accordance with previous decisions, these provisions in a bond do not necessarily cause an otherwise obvious bond to be classified as a preferred stock (R. 40). These same limitations were present in the case of *Commissioner* v. *H. P. Hood & Sons, Inc.*, 141 Fed. (2d) 467, decided by the Circuit Court of Appeals for the First Circuit on March 22, 1944. Regardless of the presence of these limitations, the Circuit Court of Appeals for the First Circuit held that the instruments involved were bonds and not stock, and the Court thereupon upheld the decision of the Tax Court, which had decided the issue in favor of the taxpayer. The Circuit Court of Appeals for the First Circuit cited with approval the decision of the Circuit Court of Appeals for the Second Circuit in the case of *O. P. P. Holding Corporation*, 76 Fed. (2d) 11. It is also interesting to note the following statement made by the Circuit Court of Appeals for the First Circuit with respect to the effect of the *Dobson* decision in a case similar to that of the Petitioner:

> "Since each case involving the question here presented must largely turn on its special facts, and since the Tax Court applied the correct rule of law, its determination is entitled to the finality indicated by Dobson v. Helvering, 320 U. S. — (1943)."

The Circuit Court of Appeals for the 7th Circuit erred in the instant case, in that it predicated its conclusion upon cases which it cites, in which the instruments involved were admittedly in the form of preferred stock, and the taxpayers were attempting to have these preferred stock instruments classified as bonds. Such is not the case here.

The form of the bond appears at R. 17, and speaks for itself. A mere glance at the instrument demonstrates that in form it is a bond and not a preferred stock. The trust indenture under which the bonds were issued appears at R. 19, et seq., and clearly shows that the instruments were in form bonds and not preferred stock. The Petitioner followed out every step normally taken by a corporation in the issuance of corporate bonds. It provided for the bonds by appropriate action of its Board of Directors and of its stockholders. It approved the trust instrument under which the bonds were to be issued. It adopted the wording of the bond which is undeniably in the form of a corporate bond and not a preferred stock. It redeemed its preferred stock, and its preferred stockholders took bonds of a face value of $102.00 for each share of preferred stock of a par value of $100.00. It sold bonds of a face value of $24,408 to Mabel K. Ronald and bonds of a face value of $10,944 to Berdina Kelley, which were paid for at face value through dividends which Mabel K. Ronald and Berdina Kelley received on common stock which they owned. During the years 1937, 1938 and 1939 all of the issued bonds remained outstanding, and none of them were redeemed or canceled. It is difficult to see what additional steps the Petitioner could, or should have taken in the issuance of the bonds. It followed the procedure which is normally followed by any corporation in the issuance of bonds. Consequently, it cannot be claimed that what it did failed to carry out the intent to create the relationship of debtor-creditor, and the Tax Court found as a fact that this relationship existed as a result of the issuance of the bonds. It is this essential finding of fact by the Tax Court which the Circuit Court of Appeals not only ignored, but took it upon itself to make its own finding of fact diametrically opposed to the finding of fact made by the Tax Court.

Conclusion

It is submitted, therefore, that the Circuit Court of Appeals clearly erred in not sustaining the decision of the Tax Court in the light of the decisions of this Court in the cases of *Dobson* v. *Commissioner of Internal Revenue*, 320 U. S. 489, and *Scottish American Investment Company, Ltd.* v. *Commissioner*, 323 U. S. 119, as well as related cases by this Court, and that regardless of the foregoing decisions, the Circuit Court of Appeals erred in deciding the case against the Petitioner from the standpoint of the merits.

Respectfully submitted,

FRANK J. ALBUS,
Attorney for Petitioner,
Earle Building,
Washington, D. C.

Washington, D. C., February, 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

BRIEF IN REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

FRANK J. ALBUS,
Counsel for Petitioner.

Table of Cases Cited

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF IN REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

The Respondent, in his brief in opposition to the granting of the Petition for Writ of Certiorari in this case, failed completely to point out why the principle announced by this Court in the cases of *Dobson* v. *Commissioner*, 320 U. S. 489 and *Scottish American Investment Co.* v. *Commissioner*, 323 U. S. 119 (discussed at Page 9, *et seq.* of Petitioner's original brief), does not sustain the Petitioner in this case. As a matter of fact, there have been a number of decisions of this Court reported subsequent to the preparation of the original brief of the Petitioner which clearly show that the Circuit Court of Appeals for the Seventh Circuit had no authority to reverse the decision of the Tax Court in this case.

Under date of January 29, 1945 this Court decided the case of *W. G. Choate* v. *Commissioner of Internal Revenue*, No. 93, October term, 1944. In the *Choate* case, the decision of the Tax Court in favor of the taxpayer turned upon its finding of fact that a cash sale of equipment had been made. The Circuit Court of Appeals for the Tenth Circuit reversed the Tax Court. This Court, in holding that the decision of the Tax Court was not reviewable by the Circuit Court of Appeals, said:

> "In the second place, the Tax Court found that the parties intended a cash sale of the equipment. That question is argued here as if it were open for redetermination by us. It is not. It is the kind of issue reserved for the Tax Court under Dobson v. Commissioner, 320 U. S. 489 and Wilmington Company v. Helvering, 316 U. S. 164, 167-168."

It will be noted that the Tax Court found that the parties *intended* a cash sale of the equipment, and that this determination on the part of the Tax Court was not reviewable by the Circuit Court of Appeals. In the instant case, at R. 40, the Tax Court held that by the issuance of the debentures, the holders thereof became creditors of the corporation, and that under the facts in the case, they had the right to change to the creditor-debtor basis. The entire foundation of the decision of the Circuit Court of Appeals is that the holders of the debentures did not become creditors of the corporation—a conclusion directly opposite to the conclusion reached by the Tax Court.

Under date of March 5, 1945, this Court decided the case of *Commissioner* v. *Wemyss*, No. 629, October term, 1944. In this case, the Tax Court had held that the full value of stock transferred to the prospective wife of the donor, in order to compensate her against the loss of her interest in a trust should she marry the donor, was subject to the gift

tax. The Circuit Court of Appeals for the Sixth Circuit reversed the Tax Court and held that there was no "donative intent". This Court, in holding that the Circuit Court of Appeals had no authority to reverse the Tax Court, said:

> "The Tax Court in effect found the transfer of the stock to Mrs. More was not made at arm's length in the ordinary course of business. It noted that the inducement was marriage, took account of the discrepancy between what she got and what she gave up, and also of the benefit that her marriage settlement brought to her son. These were considerations the Tax Court could justifiably heed, and heeding, decide as it did. Its conclusion on the issue before it was no less to be respected than were the issues which we deemed it was entitled to decide as it did in Dobson v. Commissioner, 320 U. S. 489 (31 AFTR 773), Commissioner v. Heininger, 320 U. S. 467 (31 AFTR 783), Commissioner v. Scottish American Co., 323 U. S. 119 (Paragraph 72,005 1945 Fed.)"

In the instant case, the Tax Court found that the issuance of the bonds was an arms-length transaction in the ordinary course of business. The Circuit Court of Appeals ignored this holding, and concluded that the issuance of the bonds was merely "accounting hocus-pocus" (R. 59). The decision of this Court in the *Wemyss* case clearly shows that the holding of the Tax Court in the instant case was final, and that it was not subject to review by the Circuit Court of Appeals.

Under date of March 12, 1945, this Court decided the case of *Commissioner* v. *Court Holding Company*, No. 581, October term, 1944. The question in this case was whether a certain sale of property had been made by a corporation, or if the sale had been made by the stockholders after the corporation had been "liquidated". The Tax Court held

that the corporation was taxable on the gain. The Circuit Court of Appeals for the Fifth Circuit reversed the Tax Court, and held that the sale had been made by the stockholders. This Court reversed the Circuit Court and said:

> "The answer depends upon whether the findings of the Tax Court that the whole transaction showed a sale by the corporation rather than by the stockholders were final and binding upon the Circuit Court of Appeals."
>
> * * * * * * *
>
> "The Tax Court concluded from these facts that, despite the declaration of a 'liquidating dividend' followed by the transfers of legal title, the corporation had not abandoned the sales negotiations; that these were mere formalities designed 'to make the transaction appear to be other than what it was', and thus avoid tax liability. The Circuit Court of Appeals drawing different inferences from the record, held that the corporation had 'called off' the sale, and treated the stockholders' sale as unrelated to the prior negotiations.
>
> "There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts.' Dobson v. Commissioner, 320 U. S. 489 (31 AFTR 773); Commissioner v. Heininger, 320 U. S. 467 (31 AFTR 783); Commissioner v. Scottish American Investment Co., 323 U. S. 119."

The decision of this Court in the *Court Holding Company* case again clearly shows that the Seventh Circuit had no authority to reverse the Tax Court in the instant case.

It is interesting to note how the Commissioner of Internal Revenue can vacillate in his arguments, depending upon which side of a particular case he happens to be on. No better statement of the position which the Petitioner in the instant case is taking could be made than that made by the Commissioner of Internal Revenue at Pages 11 and 12 and also Page 16 of his brief before this Court in the case of

Commissioner of Internal Revenue v. *Court Holding Company*, No. 581, October term, 1944, decided March 12, 1945. On the other hand, the Petitioner would be willing to accept as its argument in the instant case the position which the Commissioner of Internal Revenue took at Pages 25 and 26 of his brief in the case of *Commissioner of Internal Revenue* v. *William H. Wemyss*, No. 629, October term, 1944, decided March 5, 1945. Certainly it was never intended that the principle of the *Dobson* case and the *Scottish-American Investment Company* case was to apply only to those cases where the Circuit Court of Appeals reverses a decision of the Tax Court that was in favor of the Government. This is clearly borne out by the fact that in both of these cases, the decisions of the Tax Court were in favor of the taxpayers, and this Court held that the Circuit Courts of Appeals were in error in reversing the decisions of the Tax Court.

The Tax Court in the instant case held that by the issuance of the bonds, the holders thereof intended to and did become creditors of the corporation, and in accordance with the very arguments which the Commissioner of Internal Revenue made in the briefs referred to above, the decision of the Tax Court in this respect was final.

WHEREFORE, it is respectfully submitted that the Petition for Writ of Certiorari in the instant case should be granted, and that the decision of the Seventh Circuit should be reversed.

Respectfully submitted,

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FILE COPY

Supreme Court of the United States

OCTOBER TERM, 1945

No. 36

THE JOHN KELLEY COMPANY
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the Tax Court of the United States (R. 33-40) is reported in 1 T. C. 457. The opinion of the Circuit Court of Appeals (R. 55-59) is reported in 146 F. (2d) 466.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on December 21, 1944 (R. 60). Petition for Writ of Certiorari was filed on February 14, 1945, and granted on April 30, 1945 (R. 61). Jurisdiction of this Court rests on Sec. 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented

The following questions are presented:

(1) Did the Circuit Court of Appeals for the Seventh Circuit have the right to reverse the decision of the Tax Court on the basis of a fact finding made by the Circuit Court, which finding is diametrically opposed to the finding made by the Tax Court?

(2) Were the debentures issued by the Petitioner on July 1, 1937, bonds, with the result that the payments made in connection therewith were interest within the provisions of Sec. 23 (b) of the Internal Revenue Code (53 Stat. 867, 880; Title 26, U. S. C., Sec. 23 (b)), and identical provisions of the Revenue Acts of 1936 and 1938, or were they stock, with the result that the payments made in connection therewith were dividends within the provisions of Sec. 115 of the Internal Revenue Code (53 Stat. 46, as amended by 53 Stat. 873; Title 26 U. S. C., Sec. 115) and similar provisions of the Revenue Acts of 1936 and 1938?

Statute Involved

Section 23 of the Revenue Act of 1936 (c. 690, Sec. 23, 49 Stat. 1658); Section 23 of the Revenue Act of 1938 (c. 289, Sec. 23, 52 Stat. 460); and Section 23 of the Internal Revenue Code (53 Stat. 12, as amended June 29, 1939, c. 247, Title II, Secs. 211 (a), 224, 53 Stat. 867, 880) all provide:

> "Section 23. Deductions from gross income. In computing net income there shall be allowed as deductions:
>
> "(b) Interest. All interest paid or accrued within the taxable year on indebtedness." * * * (Balance of section not applicable.)

Summary Statement of the Matter Involved

The Petitioner is an Indiana Corporation, with its principal place of business at Marion, Indiana (R. 34). On January 1, 1937, the Petitioner had outstanding 1,124 shares of preferred stock of a par value of $100.00 per share (R. 34). Roy F. Kelley individually owned 628 shares of the preferred stock, and he held the balance of 496 shares as Trustee for his sister, Mabel K. Ronald (R. 34). During the month of January 1937, Roy F. Kelley transferred his 628 shares of preferred stock to Mabel K. Ronald, to be held by her as Trustee for the benefit of her daughters, with a life interest in Birdena Kelley, the wife of Roy F. Kelley (R. 34).

During the month of January 1937, a special meeting of the Board of Directors of the Petitioner Corporation was held, and a plan of recapitalization was adopted (R. 34). Following this meeting, and on the same date, the shareholders of the Petitioner Corporation held a special meeting and approved the resolution adopted by the Board of Directors (R. 34). This resolution authorized the issuance of income debentures, aggregating the sum of $250,000, bearing interest at the rate of 8% per annum, and authorized the execution of a trust instrument, setting forth the terms and conditions under which the debentures were to be issued, and setting forth the powers and duties of the Trustees (R. 34 and 35). Under the resolution, the bonds were to be offered by the Trustees in exchange for the outstanding 1,124 shares of preferred stock on the basis of $102.00 in face value of debentures for each share of preferred stock, and for the purpose of raising additional capital to expand the business of the Petitioner in the field of finance, the Trustees were to offer any and all unissued debentures for sale at face value to the shareholders of the corporation (R. 35).

The trust agreement was entered into, and on July 1, 1937, the holders of the 1,124 shares of preferred stock

surrendered their stock to the corporation and received bonds in the face amount of $114,648. On the same date, Mabel K. Ronald subscribed for $24,408 of the bonds, and Birdena Kelley subscribed for $10,944 of the bonds. These amounts were carried against Mabel K. Ronald and Birdena Kelley in open accounts on the books of the Petitioner Corporation, and the liability was later satisfied by the credit of dividends received by them on common stock which they owned (R. 35).

During the period from July 1 to December 31, 1937; January 1 to December 31, 1938, and January 1 to December 31, 1939, the Petitioner had outstanding bonds of a face amount of $150,000, in respect of which $6,000, $12,000, and $12,000 for each period, respectively, were set up on the books of the Petitioner Corporation as accrued interest thereon. The amounts so accrued were paid and were claimed by the Petitioner as deductions in computing its taxable net income for the respective calendar years 1937, 1938 and 1939. These deductions were disallowed by the Respondent on the theory that the payments represented dividends on stock and not interest on indebtedness (R. 36 and R. 8, par. (b)). The Tax Court of the United States reversed the action taken by the Respondent, and held that the debentures were bonds, with the result that the amounts paid in connection therewith were interest payments which the Petitioner was entitled to deduct in arriving at net income (R. 33, *et seq.*).

The Commissioner of Internal Revenue appealed the decision of the Tax Court to the Circuit Court of Appeals for the Seventh Circuit. That court reversed the decision of the Tax Court on the basis of its own finding of fact that the issuance of the bonds was not bona fide, which finding is diametrically opposed to the finding of fact made by the Tax Court. The Circuit Court based its conclusion upon its finding of fact that "It was all a matter of accounting hocus-pocus, guided by a little too clever legal planning which eventuated in a rather flimsy scheme to avoid payment of

taxes" (R. 59). This finding of fact upon which the determination of the Circuit Court rests, is the direct opposite of the finding made by the Tax Court; namely, that the transaction was bona fide, and that as a result thereof, the bondholders became creditors of the Petitioner Corporation (R. 40).

Specification of Errors to Be Urged

The Circuit Court of Appeals erred:

1. In assuming jurisdiction to make a finding of fact that the issuance of the bonds by Petitioner was "all a matter of accounting hocus-pocus" (R. 59), which finding by the Circuit Court of Appeals is diametrically opposed to the finding of the Tax Court that the issuance of the bonds was bona fide and that as a result thereof the bondholders became creditors of the Petitioner Corporation.

2. In stating that "There is no dispute as to the facts" (R. 55), and then changing the keystone fact upon which the decision of the Tax Court rested.

3. In holding that the issuance of the bonds did not create the relationship of debtor and creditor between the Petitioner Corporation and the bondholders.

4. In holding that the instruments involved are preferred stock and not bonds.

5. In reversing the judgment of the Tax Court.

Summary of Argument

I

The Petitioner is contending that the Circuit Court of Appeals clearly erred in not only ignoring an essential fact

found by the Tax Court, but in actually basing its decision on a finding of fact made by it, which is diametrically opposed to the finding made by the Tax Court. The Petitioner contends that this action on the part of the Circuit Court of Appeals is in direct conflict with the decisions of this Court in the cases of *Dobson* v. *Commissioner of Internal Revenue*, 320 U. S. 489, *Commissioner* v. *Scottish American Investment Company, Ltd.*, 323 U. S. 119, *Choate* v. *Commissioner*, 324 U. S. 1, *Commissioner* v. *Wemyss*, 324 U. S. 303, as well as other decisions by this Court cited in footnote (22) in the Dobson case.

II

The Petitioner is further contending that from the standpoint of the merits, the decision of the Tax Court in holding that the instruments involved are bonds, is correct and that the decision of the Circuit Court of Appeals for the Seventh Circuit in holding that the instruments are stock, is in direct conflict with the decision of the Circuit Court of Appeals for the First Circuit in the case of *Comm.* v. *H. P. Hood & Sons, Inc.*, 141 Fed. (2d) 467, as well as other cases involving the same point.

ARGUMENT

Point I

THE DECISION OF THE CIRCUIT COURT OF APPEALS IS CLEARLY IN CONFLICT WITH THE DECISIONS OF THIS COURT IN THE CASES OF *DOBSON* v. *COMMISSIONER*, 320 U. S. 489, *COMMISSIONER* v. *SCOTTISH AMERICAN INVESTMENT COMPANY, LTD.*, 323 U. S. 119, AS WELL AS MANY OTHER SIMILAR CASES DECIDED BY THIS COURT.

Under date of December 20, 1943, this Court decided the case of *Dobson* v. *Commissioner of Internal Revenue*, 320

U. S. 489, and set forth the circumstances under which a Circuit Court of Appeals may, and may not reverse a decision of the Tax Court of the United States. In the Dobson case, this court said:

> "The judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the Administrative body."

This Court further said:

> "When the Court cannot separate the elements of a decision, so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand."

The Circuit Court of Appeals for the Seventh Circuit found no "clear-cut mistake of law" in the instant case. It merely refused to recognize a finding of fact made by the Tax Court; namely, that the issuance of the bonds was a bona fide transaction. It made its own finding of fact; namely that the transaction was "all a matter of accounting hocus-pocus" (R. 59), which finding is the direct opposite of the finding made by the Tax Court. The decision of the Circuit Court of Appeals is based squarely on the aforesaid finding of fact made by it. Even before the decision by this Court in the Dobson case, it was an established rule of appellate jurisprudence that an appellate court could not disturb the facts found by the trial court, unless there was no evidence to support the finding. There was abundant evidence before the Tax Court to support its finding that the issuance of the bonds was bona fide, and, therefore, the Circuit Court of Appeals for the Seventh Circuit had no authority to reverse this finding.

In the Dobson case, this Court further said:

> "Where no Statute or Regulation controls, the Tax Court's selection of the course to be followed is no more reviewable than any other question of fact."

* * * * * * *

> "The Statute gives no inkling as to the correctness or incorrectness of the Tax Court's view, and we can find no compelling reason to substitute our judgment."

The foregoing statements apply with compelling force in the instant case. There is absolutely nothing in the Internal Revenue Code that in any way aids in the solution of the problem as to whether an instrument is a bond or a preferred stock. Neither the word "bond," nor the word "stock," is defined in the Internal Revenue Code, and as far as the decision in this case is concerned, the Tax Court could have reached its conclusion without referring to the Internal Revenue Code. Consequently, this is the very type of case which this Court had in mind when it made the above statements in the Dobson case. The principle of the Dobson case has been cited and followed by every Circuit Court of Appeals, and as a matter of fact, it has been followed by the Circuit Court of Appeals for the Seventh Circuit in the cases of *George F. Fox* v. *Harrison*, 145 Fed. (2d) 521, and *Superior Coal Company* v. *Commissioner*, 145 Fed. (2d) 597.

A case which more clearly establishes error on the part of the Circuit Court of Appeals in the instant case is that of *Commissioner* v. *Scottish American Investment Company, Ltd.*, 323 U. S. 119, decided by this Court on December 4, 1944, for the reason that the decision of the Tax Court in that case rested squarely on its finding of fact that a certain transaction was bona fide. The sole question in the case was whether an office maintained in the United States by three foreign corporations was a bona fide office or a sham. The Tax Court found as a fact that the office maintained by the taxpayers was a bona fide office, and it therefore decided the case in favor of the taxpayers. The Third Circuit reversed the Tax Court on the basis of its own finding of fact that the office maintained in the United States by the taxpayers was a sham. This Court reversed the Third Circuit, and held that court had no right to disturb the finding of the Tax Court. During the course of its opinion, this Court said:

"The sole issue revolves about the propriety of *the inferences and conclusions* drawn from the evidence by the Tax Court." (Italics supplied.)

* * * * * * * *

"The Tax Court has the primary function of finding the facts in tax disputes, weighing the evidence, *and choosing from among conflicting factual inferences and conclusions* those which it considers most reasonable. *The Circuit Court of Appeals has no power to change or add to those findings of fact, or to re-weigh the evidence.*" (Italics supplied.)

* * * * * * * *

"The judicial eye must not in the first instance rove about, searching for evidence to support other conflicting inferences and conclusions which the judges or the litigants may consider more reasonable or desirable."

* * * * * * * *

"We cannot say that it was unreasonable for the Tax Court to conclude that this office was more than a sham, and that it was used for the regular transaction of business."

* * * * * * * *

"We do not decide or infer that the contrary inferences and conclusions urged by the Commissioner are entirely unreasonable or completely unsupported by any probative evidence. We merely hold *that such conditions are irrelevant*, so long as there is adequate support in the evidence for what the Tax Court has inferred. *It follows that the Tax Court's conclusions in this case cannot be set aside on appellate review.*" (Italics supplied.)

All of the foregoing language applies with compelling force to the action of the Circuit Court of Appeals in reversing the Tax Court in the instant case. The court held a transaction to be a sham in the face of a contrary fact finding by the Tax Court that it was bona fide. This Court in the Scottish American Investment Company, Ltd., case said that this is clearly reversible error. The Scottish American

Investment Company, Ltd., case was decided by this Court 17 days before the decision of the Circuit Court of Appeals in the instant case was released. The Circuit Court of Appeals in its opinion did not even mention the Scottish American Investment Company, Ltd., case, nor did it mention the Dobson case, although both of these cases were called to its attention before its opinion was released. The Circuit Court of Appeals cited as its authority for reversing the Tax Court, its own decision in the case of *Commissioner v. Meridian & Thirteenth Realty Company*, 132 Fed. (2d) 182, which was decided on November 5, 1942, long before this Court announced the applicable rule in the Dobson case.

The Scottish American Investment Company, Ltd., case is also of major importance from another angle. In that case, this Court said that the general principle of the Dobson case applies with the greatest possible force, where the decision of the Tax Court is such that the particular case will be "of little value as precedent." In this connection, this Court said:

> "Moreover, this case exemplifies one type of factual dispute where judicial abstinence should be pronounced. The decision as to the facts in this case, like analogous ones that precede it, is of little value as precedent. The factual pattern is too decisive and too varied from case to case to warrant a great expenditure of appellate court energy on *unravelling conflicting inferences*. The skilled judgment of the Tax Court, which is the basic fact-finding and *inference-making body* should thus be given wide range in such proceedings." (Italics supplied.)

The Circuit Court of Appeals, by its own admission, recognized that the instant case is one falling squarely within the above category. At R. 56, the Circuit Court of Appeals said:

> "In deciding cases of this kind, the various provisions of the instrument evidencing the obligation in the light of the surrounding circumstances *in each case*

determine whether the relationship created is proprietary or that of debtor-creditor. *Each case stands on its own feet.*" (Italics supplied.)

The Circuit Court of Appeals readily admitted that each case involving the question that is present in the instant case "stands on its own feet," but regardless of this admission and regardless of the fact that the Circuit Court of Appeals had the benefit of the decision of this Court in the Scottish American Investment Company, Ltd., case before it decided the instant case, it took it upon itself to reverse the Tax Court, in direct violation of the admonition set forth by this Court in the Scottish American Investment Company, Ltd., case. Furthermore, in its opinion (R. 55), the Circuit Court of Appeals said, "There is no dispute as to the facts," but regardless of this statement, the Circuit Court then proceeded to not only ignore the finding of the Tax Court that the transaction was bona fide, but to actually make its own finding, which is diametrically opposed to the finding of the Tax Court.

Under date of January 29, 1945, this Court decided the case of *W. G. Choate* v. *Commissioner*, 324 U. S. 1. In the Choate case, the decision of the Tax Court in favor of the taxpayer turned upon its finding of fact that a cash sale of equipment had been made. The Circuit Court of Appeals for the Tenth Circuit reversed the Tax Court. This Court, in holding that the decision of the Tax Court was not reviewable by the Circuit Court of Appeals, said:

> "In the second place, the Tax Court found that the parties intended a cash sale of the equipment. That question is argued here as if it were open for redetermination by us. It is not. It is the kind of issue reserved for the Tax Court under *Dobson* v. *Commissioner*, 320 U. S. 489, and *Wilmington Company* v. *Helvering*, 316 U. S. 164, 167-168."

It will be noted that in the Choate case, the Tax Court found that the parties *intended* a cash sale of the equipment,

and that this determination by the Tax Court was not reviewable by the Circuit Court of Appeals. In the instant case, the net effect of the holding of the Tax Court (R. 40) was that by the issuance of the debentures, the holders thereof intended to, and did, become creditors of the corporation, and that they had "the right to change to the creditor-debtor basis." The entire foundation of the decision of the Circuit Court of Appeals is based upon its finding of fact that the holders of the debentures did not become creditors of the corporation, which finding is in direct opposition to the finding of the Tax Court.

Under date of March 5, 1945, this Court decided the case of *Commissioner* v. *Wemyss*, 324 U. S. 303. In this case the Tax Court had held that the full value of stock transferred to the prospective wife of the donor, in order to compensate her against the loss of her interest in a trust should she marry the donor, was subject to the gift tax. The Circuit Court of Appeals for the Sixth Circuit reversed the Tax Court and held that there was no "donative intent." This Court, in holding that the Circuit Court of Appeals had no authority to reverse the Tax Court, said:

> "The Tax Court in effect found the transfer of the stock to Mrs. More was not made at arm's length in the ordinary course of business. It noted that the inducement was marriage, took account of the discrepancy between what she got and what she gave up, and also to the benefit that her marriage settlement brought to her son. These were considerations the Tax Court could justifiably heed, and heeding, decide as it did. Its conclusion on the issue before it was no less to be respected than were the issues which we deemed it was entitled to decide as it did in *Dobson* v. *Commissioner*, 320 U. S. 489, *Commissioner* v. *Heininger*, 320 U. S. 467, *Commissioner* v. *Scottish American Co.*, 323 U. S. 119."

In the instant case, the Tax Court found that the issuance of the bonds was an arms-length transaction in the ordinary

course of business. The Circuit Court of Appeals ignored this holding, and concluded that the issuance of the bonds was merely "accounting hocus-pocus" (R. 59). The decision of this Court in the Wemyss case clearly shows that the holding of the Tax Court in the instant case was final, and that it was not subject to review by the Circuit Court of Appeals.

Under date of March 12, 1945, this Court decided the case of *Commissioner* v. *Court Holding Company*, 324 U. S. 331. The question in this case was whether a certain sale of property had been made by a corporation, or if the sale had been made by the stockholders after the corporation had been "liquidated." The Tax Court held that the corporation was taxable on the gain. The Circuit Court of Appeals for the Fifth Circuit reversed the Tax Court, and held that the sale had been made by the stockholders. This Court reversed the Circuit Court and said:

> "The answer depends upon whether the findings of the Tax Court that the whole transaction showed a sale by the corporation rather than by the stockholders were final and binding upon the Circuit Court of Appeals."
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> "The Tax Court concluded from these facts that despite the declaration of a 'liquidating dividend' followed by the transfers of legal title, the corporation had not abandoned the sales negotiations; that these were mere formalities designed 'to make the transaction appear to be other than what it was,' and thus avoid tax liability. The Circuit Court of Appeals *drawing different inferences from the record*, held that the corporation had 'called off' the sale, and treated the stockholders' sale as unrelated to the prior negotiations. (Italics supplied.)
>
> "There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. *Dobson* v. *Commissioner*, 320 U. S. 489; *Commissioner* v. *Heininger*, 320 U. S. 467; *Commissioner* v. *Scottish American Investment Co.*, 323 U. S. 119."

The decision of this Court in the Court Holding Company case again clearly shows that the Seventh Circuit had no authority to reverse the Tax Court in the instant case.

It is interesting to note how the Commissioner of Internal Revenue can vacillate in his arguments, depending upon which side of a particular case he happens to be on. No better statement of the position of the Petitioner in the instant case could be made than the argument advanced by the Commissioner in his brief filed with this Court in the *Court Holding Company* case (No. 581, October term, 1944). At page 11 of the Commissioner's Brief in that case, he said:

> "Insofar as the decision below is premised on the inference that taxpayer abandoned the oral agreement and made a bona fide liquidation distribution, it violates the settled principle that it is the function of the Tax Court, not the Circuit Court of Appeals, to weigh the evidence, find the facts, and draw inferences from the facts. *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231; *Wilmington Co.* v. *Helvering*, 316 U. S. 164, 168; *Commissioner* v. *Scottish American Investment Co.*, decided by this Court December 4, 1944, not yet reported.
>
> "In assuming that the oral agreement was 'called off' (R. 120), the majority of the court below substituted its own view of the facts for that of the Tax Court."

On page 12 of the same Brief, the Commissioner said:

> "In assuming that the corporation was 'actually' liquidated (R. 120), the majority of the court below likewise substituted its own view of the facts for that of the Tax Court. For the Tax Court had concluded (R. 96-97) that the resolutions to liquidate and the liquidation distribution were not bona fide but 'were formal devices to which resort was had only in the attempt to make the transaction appear to be other than what it was.'"

On page 13 of the same Brief, the Commissioner said:

> "And in reaching the ultimate conclusion that the sale was in fact and substance a sale by the stockholders individually, the majority of the court below replaced the inference drawn by the Tax Court with its own."

If the foregoing statements represent sound deductions from the Dobson and the Scottish American Investment Company decisions (and this Court in deciding the Court Holding Company case said that they did), then they are also sound when applied to the arguments of the Petitioner in the instant case.

Let us now see what the Commissioner said in his Brief filed with this Court in the *Wemyss* case (No. 629, October term, 1944). At page 25 of that Brief, the Commissioner said:

> "Certainly the record contains ample evidence to sustain a finding that the transaction was a family arrangement, made with donative intent, not a business deal or bargain, at arm's length. Such a finding, implicit in the findings and opinion of the Tax Court, is entitled to finality. *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231; *Commissioner* v. *Scottish American Investment Co.*, decided by this Court, December 4, 1944.
>
> "Going beyond its powers in entering into such an inquiry, the court below found that the prospective wife bargained 'at arm's length' (R. 56), that the transaction was 'business-like' in nature (R. 56), that the consideration for the transfer was not only a promise to marry, as the Tax Court had found (R. 13, 14), but also 'a concomitant surrender by the transferee of a life income in an existing trust fund' (R. 56) and that (R. 57)—
>
> "She was agreeing upon a present transfer made to indemnify her against loss of existing property rights which would ensue in consequence of her marriage.
>
> "The court below also chose to infer that the transfer was completely disassociated from any indicia of an

> intent to avoid death taxes, that the minds of the contracting parties were not upon the effect of the transfer in the event of the death of either (R. 57), and finally, found that there was no donative intent in the transaction and held that the case was '*sui generis*, easily and correctly justiciable' (R. 57) upon this ground. This was not a necessary inference from the record, and it cannot be said that no other conclusion had substantial basis in the evidence and that a finding of donative purpose could not have been sustained on this record. On the contrary, we urge that a finding of donative intent is implicit in the Tax Court's finding and in the facts found by it and that the evidence supplies a substantial basis for such a finding."

The Tax Court in the instant case held that by the issuance of the bonds, the holders thereof intended to, and did, become creditors of the corporation, and in accordance with the very arguments which the Commissioner made in the briefs referred to above (which arguments were approved by this Court in its decisions covering the cases), the decision of the Tax Court in this respect was final.

Under date of May 21, 1945, this Court decided the case of *Commissioner* v. *Bedford*, 325 U. S. —, 65 S. Ct. 1157, and held that cash received in connection with a recapitalization was taxable as an ordinary dividend under Sec. 112 (c) (2) of the Revenue Act of 1936. The Tax Court had held that the cash received was a taxable dividend. The Circuit Court of Appeals for the Second Circuit reversed the Tax Court and held that the transaction resulted in capital gain. This Court reversed the decision of the Second Circuit. In the last sentence of the opinion, this Court said:

> "And if the case can be reduced to its own particular circumstances, rather than turn on a generalizing principle, we should feel bound to apply Dobson v. Commissioner, 320 U. S. 489, and sustain the Tax Court."

The Circuit Court of Appeals for the Seventh Circuit not only admitted that the instant case "can be reduced to its

own particular circumstances" but it went further and stated that each case of this type *must* stand "on its own feet" (R. 56). In the light of this admission, the above-quoted language by this Court clearly demonstrates the error of the Seventh Circuit in its decision in this case.

And even in the case of *Bingham's Trust* v. *Commissioner*, 325 U. S. —, 65 S. Ct. 1232, decided by this Court on June 4, 1945, wherein the majority members of this Court held that the Dobson case did not apply to the facts and the law in the case, this Court was careful to point out that it was not the type of case where it was necessary for the Tax Court "to draw an inference of fact from the basic findings." In the course of its opinion, this Court said:

> "And even when they are hybrid questions of 'mixed law and fact,' their resolution, because of the fact element involved, will usually afford little concrete guidance for future cases, and reviewing courts will set aside the decisions of the Tax Court only when they announce a rule of general applicability, that the facts found fall short of meeting statutory requirements. Dobson v. Commissioner, supra, 502; Commissioner v. Estate of Bedford, No. 710, decided May 21, 1945; cf. Paul, 'Dobson v. Commissioner,' 57 Harv. Law Rev. 753, at 828-832, 836-837."

In a concurring opinion by Mr. Justice Frankfurter, in which Mr. Justice Roberts and Mr. Justice Jackson joined, it was stated that the decision of the Second Circuit should be reversed and the decision of the Tax Court sustained, solely on the basis of the Dobson principle.

In the Bingham case there was involved a question of statutory construction. In the instant case, no such question is involved. The Petitioner has no quarrel with the Respondent as to the meaning of the word "indebtedness" or the word "interest" as used in Sec. 23 of the Internal Revenue Code. The argument centers around a matter wholly outside the Internal Revenue Code; namely, whether under the circumstances of the case the relationship of debtor

and creditor was established between the Petitioner Corporation and the holders of the instruments involved. Once this problem is solved, then the application or the non-application of Sec. 23 of the Internal Revenue Code is automatic. And in the determination of the question as to whether the relationship of debtor and creditor does exist, the primary question to be considered is the intent of the parties. In the case of *Commissioner* v. *Proctor Shop, Inc.*, 82 F. (2d) 792, the Circuit Court of Appeals for the Ninth Circuit said: "The real intention of the parties is to be sought." This is certainly a question for determination by the Tax Court and not the Circuit Court of Appeals. As the Circuit Court of Appeals for the Second Circuit said in footnote (2) in the case of *Janeway* v. *Commissioner*, 147 F. (2d), 602:

> "Involved is the question of the credibility of the witness as to the taxpayer's intentions, a question, surely, for the Tax Court."

The Tax Court in the instant case found, after considering all of the facts, that the relationship of debtor and creditor existed. The Circuit Court of Appeals by drawing different inferences from the facts found that this relationship did not exist. In doing so, it clearly committed error, as demonstrated by the decisions of this Court, referred to above.

The decision of the Seventh Circuit in the instant case is in direct conflict with its own decisions in the cases of *George F. Fox* v. *Harrison*, 145 F. (2d) 521, and *Superior Coal Company* v. *Commissioner*, 145 F. (2d) 597, both of which cases were decided by the Seventh Circuit prior to the release of its decision in the instant case. In the Fox case, the trial court found as a fact that the redemption of stock by a corporation was not accomplished at such time and in such manner as to make the redemption essentially equivalent to the distribution of a taxable dividend within the meaning of Sec. 115 (g) of the Internal Revenue Code. The taxpayer appealed the decision of the trial court to the

Circuit Court of Appeals for the Seventh Circuit. The Circuit Court of Appeals for the Seventh Circuit, on the authority of the Dobson case, held that it was without power to reverse the decision of the lower court. It will be noted that in the Fox case, the Circuit Court of Appeals held on the authority of the Dobson case, that it could not reverse the decision of the trial court, which had held that the distribution was not a dividend within the meaning of Sec. 115 (g) of the Internal Revenue Code. In the instant case, the Tax Court found that the distributions were interest payments and not dividends within Sec. 115 of the Internal Revenue Code, yet the Circuit Court of Appeals reversed the conclusions of the Tax Court, and held that the distributions were dividends within the meaning of that section.

In the Superior Coal Company case, the Tax Court had found as a fact that certain real property had become worthless prior to the taxable year involved. The taxpayer appealed the decision of the Tax Court to the Seventh Circuit, and that court held, on the authority of the Dobson case, that it could not disturb the finding of the Tax Court.

The Circuit Court of Appeals did not mention the Fox case nor the Superior Coal Company case in its opinion in the instant case, and it made no attempt whatever to show in what respects the instant case is distinguishable from these cases.

In view of the basis upon which the Circuit Court of Appeals predicated its decision, its holding is tantamount to a conclusion that the taxpayer committed a fraud. The decision of the Circuit Court is not based upon the legal effect of any provision in the debentures and the trust instrument issued in connection therewith, but is based upon a conclusion that "it was all a matter of accounting hocus-pocus." This is the same thing as saying that the parties committed a fraud in the issuance of the bonds. At no stage of the proceeding has the Commissioner of Internal Revenue contended that the parties committed a fraud. He did not assert fraud in his notice of deficiency, nor did he

raise this issue by pleading before the Tax Court. Furthermore, since the question of fraud is a pure question of fact, such an issue would most assuredly fall within the sole jurisdiction of the Tax Court under the Dobson case. As Mertens states in his Law of Federal Income Taxation, Sec. 55.11, Vol. 10, p. 18:

> "Fraud cases are illustrative authorities because they are premised largely on intent, which is proven not only by records and testimony, but by the appearance and manner of witnesses and inferences to be drawn therefrom."

The foregoing more forcefully emphasizes the clear-cut error of the Circuit Court of Appeals in reversing the Tax Court in the instant case.

The most that can be said of the decision of the Circuit Court of Appeals is that if that court had been the trial court it would have reached a conclusion different from that reached by the Tax Court, based on the "conflicting factual inferences and conclusions" to be drawn from the evidence. But the Circuit Court of Appeals was not the trial court. It is the function of the Tax Court to hold the trial and to draw conclusions from conflicting factual inferences. In the exercise of this function, the Tax Court did determine the inferences and conclusions to be drawn from the evidence and reached the conclusion that the instruments were bonds and that the holders thereof became creditors of the corporation. Such a holding by the Tax Court is not subject to review by a Circuit Court of Appeals.

Point II

THE DECISION OF THE TAX COURT WAS CORRECT ON THE BASIS OF THE MERITS

If we disregard the principle of the Dobson and related cases and consider the case solely from the standpoint of the merits, the decision of the Tax Court was correct.

At the outset, the Petitioner wishes to point out a most important fact in this case, which is, that the instrument involved is unquestionably and undeniably in the form of a bond and not in the form of a capital stock certificate. This becomes of vital importance, for the reason that in the vast majority of cases involving the question of "stock v. bonds," the instruments involved were in form, preferred stock, and the taxpayers were contending that in reality the instruments were bonds. In the instant case, "the shoe is on the other foot." The instrument, in form, is a bond and it is the Government which is claiming that it is something other than what it purports to be.

A review of the decided cases dealing with the question as to whether an instrument is a certificate of stock, or a bond, clearly shows that the form of the instrument is the most important fact to be taken into consideration in the case. While the form of the instrument is not absolutely controlling, the decided cases show that the party who claims that the instrument is something other than what it purports to be on its face is at a decided disadvantage. This is due to the fact that the board of directors of a corporation know the difference between a bond and a preferred stock, and that by adopting the form of the instrument it is presumed that the board of directors intended the instrument to be exactly what it is in form. In the case of *Northern Fire Apparatus Company*, 11 BTA 355, the Tax Court at p. 361 said:

> "In law there are material differences between corporate stock and corporate bonds. Boards of directors are presumed to know those differences and when such board issues certificates, the name or designation given such certificates by the board of directors should be given effect, unless there is convincing evidence that the board did not say what it intended to mean, and further that what it intended to say is evidenced so clearly and publicly that creditors will not be misled."

The Tax Court stated that the name given to the instrument will prevail unless there is "convincing evidence" that the board of directors did not say what it intended to. There certainly is no convincing evidence in the present case to show that the board of directors intended the instruments to be anything other than bonds. As a matter of fact, there is convincing evidence to show that the instruments were intended to be bonds.

In the appeal of *Kentucky River Coal Corp.*, 3 BTA 644, 649, the Tax Court said:

> "The first thing to be considered in the determination of whether the shares of debenture stock issued by the taxpayer and outstanding during the year 1919 are obligations of the taxpayer or a part of its capital stock, is the name which has been given to such shares of debenture stock. It is not a thing to be ignored, for it is not lightly to be assumed that parties have given an erroneous name to their transaction."

In the appeal of *O. P. P. Holding Corporation*, 30 BTA 337, 340, the Tax Court said:

> "It is the generally accepted rule that the name given to the instrument is not conclusive of its character and that inquiry may be made as to its real character; but it is not lightly to be assumed that parties have given an erroneous name to their transaction. *Leasehold Bldg. Co.*, 3 BTA 1129; *Kentucky River Coal Corp.*, 3 BTA 644. Its true nature will be determined by looking to its terms and legal effect. *I. Unterberg & Co.*, 2 BTA 274."

When the *O. P. P. Holding Corporation* case was considered by the Circuit Court of Appeals for the Second Circuit, 76 F. (2d) 11, that Court said:

> "Stocks and bonds both evidence a contract between their holders and the issuing corporation, and, in construing this contract, the language used in reducing it

to writing will be indicative of the intention of the parties."

See also the case of *H. R. DeMilt Company*, 7 BTA 7.

A review of the form of the instrument involved in this proceeding (Exhibit "E," R. 17) demonstrates beyond any question that in form it is a bond. It is referred to at the top of the instrument as "Form of Debenture." It is headed "The John Kelley Company 20-Year 8% Income Debenture." Throughout the entire instrument it is referred to as "debenture" and "this debenture bond." The earnings to accrue on the instrument are referred to as "interest." The same comment applies to the trust instrument under which the bonds were issued and which appears in the record as Exhibit "F," R. 19. At no place do the words "stock" or "preferred stock," or "dividends" appear in the bond itself or in the trust instrument.

When the foregoing facts are taken into consideration and it is realized that the characteristics established by the instrument logically support the name which the board of directors assigned thereto, the conclusion is inevitable that the instrument is a bond and not a preferred stock. Imagine the chance the Petitioner would have if it were contending that the amount of the outstanding bonds should be included in its invested capital on the theory that the holders thereof are stockholders rather than bondholders. Such a contention on the part of the Petitioner would be dismissed as fantastic.

The importance of the form of the instrument is illustrated by the case of *Pacific Southwest Realty Company* v. *Commissioner*, 128 F. (2d) 815, decided by the Circuit Court of Appeals for the Ninth Circuit. In that case the instruments were admittedly in the form of preferred stock. The Circuit Court of Appeals decided the case against the taxpayer and held that the instruments were preferred stock.

In a concurring opinion, Judge Healy made the following statement:

> "If they had been denominated 'bonds' rather than preferred stocks, I apprehend that nobody would contend that they were not true evidences of debt or that the returns paid thereon were anything other than interest."

In other words, if the instruments in the Pacific Southwest Realty Company case had been in the form of bonds and every other essential element had been the same as it actually was, the decision would have been in favor of the taxpayer for the reason that when Judge Healy stated that if these conditions had obtained "nobody would contend that they were not true evidences of debt," he certainly was including his colleagues.

By holding that the issuance of the bonds was merely a matter of "accounting hocus-pocus," the Circuit Court of Appeals reversed the finding of the Tax Court that the parties intended to become creditors of the corporation. Regardless of anything else that may have been in the case for the consideration of the Circuit Court of Appeals, certainly the question of intent was not included. As the Petitioner has already pointed out in this brief, the question of "intent" is the purest kind of question of fact. The Tax Court held that it was the intent of the bondholders to become creditors, and the only possible question for review by the Circuit Court of Appeals was to ascertain if the steps taken were sufficient in law to carry out that intent.

The Petitioner took every step normally taken in the issuance of corporate bonds. It provided for the bonds by appropriate action of its board of directors and its stockholders. It approved the trust instrument under which the bonds were to be issued. It adopted the wording of the bond which is undeniably in the form of the usual corporate bond. It redemmed its preferred stock and its preferred stockholders took bonds of a face value of $102 per share for each

share of preferred stock of a par value of $100. In addition, the Petitioner sold bonds of a face value of $24,408 to Mabel K. Ronald and bonds of a face value of $10,944 to Birdena Kelley, which were paid for at face value through dividends which Mabel K. Ronald and Birdena Kelley received on common stock which they owned. During the years 1937, 1938 and 1939, all of the issued bonds remained outstanding and none of them were redeemed or cancelled.

It is difficult to see what additional steps the Petitioner could or should have taken in the issuance of the bonds. It followed the procedure which is normally followed by any corporation in the issuance of bonds. Consequently, it cannot be claimed that what it did failed to carry out the intent to create the relationship of debtor and creditor—and the Tax Court found, as a fact, that this relationship exists.

The only unusual circumstances found in the entire transaction is the fact that the payment of interest is conditioned upon profits of the company and that the obligation under the bonds is subordinate to the claims of general creditors. But the Tax Court considered both of these points and held that they did not change the bond into a preferred stock.

In the case of *H. R. DeMilt Company*, 7 BTA 7, the bonds provided that the interest was to be "payable only out of surplus or net profits." In that case it was the taxpayer who claimed that the bonds were stock, since the taxpayer wanted to include them in invested capital. In speaking of the interest provisions the Tax Court said:

> "Nor do we think the fact that the interest was to be paid out of 'surplus or net profits' would be controlling. We are concerned here with the principal itself, which is an enforcible lien against the assets of the corporation and which is subject to repayment in twenty years."

Furthermore, the bonds involved in the DeMilt case contained a provision whereby the obligation of the company

under the bonds was subordinate to the claims of general creditors, but the Tax Court held that such a provision did not cause the instrument to be classified as a preferred stock. See also the cases of *Commissioner* v. *Page Oil Co.*, 129 F. (2d) 748, *Idaho Lumber & Hardware Co.*, T. C. Memo. Dec., Par. 45,084, P.-H. Memo Service, *Fidelity Finance Service, Inc.*, T. C. Memo. Dec., Par. 42,467, P.-H. Memo. Service, and *S. Glaser & Sons, Inc.*, T. C. Memo. Dec., Par. 44,170, P.-H. Memo. Service.

In the case of *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. (2d) 833, the *Seventh Circuit* held that the subordination of the claims of the holders of the instruments to general creditors of the issuing corporation was not sufficient to cause a bond to be classified as preferred stock and the court reached this conclusion regardless of the fact that in the Jones case the instrument, in form, was a stock certificate, and not a bond.

A similar provision was contained in the bonds involved in the appeal of *O. P. P. Holding Corporation*, 30 BTA 337. In that case the Tax Court, at page 341, said:

> "In the instant case there is nothing in the instrument to make the holder thereof a stockholder. It is true that the debenture bonds are subordinate to the claims of all creditors of the corporation, but this does not mean that the holder of a debenture bond is not also a creditor."

The Commissioner of Internal Revenue appealed the case of O. P. P. Holding Corporation to the Circuit Court of Appeals for the Second Circuit and the decision of the Tax Court was sustained in 76 F. (2d) 11. In speaking of the priority of the claims of general creditors over the claims of bondholders, the Circuit Court said:

> "We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid a definite sum at a fixed time marks

'his relationship to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the contingency of payment."

The Second Circuit hit the keynote when it stated that the vital difference between a creditor and a shareholder is the obligation of payment on a date definite. A stockholder has an investment in the business of the corporation and he is not entitled to receive a return on his investment until the company is liquidated or the board of directors decide to redeem his stock. On the other hand, a bondholder has an instrument that becomes due on a fixed date and on that date the bondholder is entitled to receive payment out of the assets of the company even though such payment may not be in accord with the wishes of the board of directors. Since the definite maturity date is the outstanding characteristic of a bond as compared to preferred stock, let us look at this feature as it applies to the bor of Petitioner.

As far as the bond itself is concerned, there can be no question about the definiteness of the liability of the Petitioner to pay. The very first statement in the bond reads as follows:

"The John Kelley Company, an Indiana corporation, for value received, promises to pay to the bearer on the 31st day of December 1956, the sum of $1,000 in lawful money of the United States of America at the office of the Company in Marion, Indiana. * * *"

The trust indenture (Exhibit "F," R. 19) under which the bonds were issued provides as follows in Sec. 1 of Article II:

"Section 1. The Company covenants that it will promptly pay or cause to be paid to every holder of any debenture issued hereunder the principal and interest accruing thereon in lawful money of the United States of America, on the dates and at the place and in the manner mentioned in said debentures. The interest on

the debentures shall be payable only upon presentation thereof for endorsement thereon."

Sec. 2 of Article IV of the trust instrument provides as follows:

"Section 2. The company covenants that (a) in case default shall be made in the punctual payment of any instalment of interest on any outstanding debenture or debentures and such default shall have continued for a period of two (2) years; or (b) in case default shall be made in the payment of the principal of any such debenture or debentures when the same shall become payable, whether upon maturity or upon call or declaration as provided in this Trust Agreement, then upon demand of the Trustees the Company will pay to the Trustees for the benefit of the holders of the debentures issued hereunder and then outstanding, the whole amount which then shall have become due and payable on all such debentures then outstanding and in addition thereto such further amount as shall be sufficient to cover the costs and expenses of collection, including a reasonable compensation to the Trustees, their agents, attorneys and counsel, and any expenses or liability incurred by the Trustees hereunder. In case the Company shall fail forthwith to pay such amount on such demand, the Trustees in their own names and as Trustees of any express trust shall be entitled and empowered to institute such action or proceeding at law or in equity, as may be advised by counsel, for the collection of the sums so due and unpaid and may prosecute any such action or proceeding to judgment or final decree and may enforce any such judgment or decree in the manner provided by law."

And in the last paragraph of Sec. 5 of Article IV it is provided:

"Provided, however, that nothing in this Trust Agreement shall affect or impair the obligation of the Company, which is unconditional and absolute, to pay, at the date of maturity therein expressed the principal

of the debentures to the respective holders thereof, or affect or impair the right of action of such holders to enforce such payment, subject only to the prior right of the Trustees, if exercised promptly in accordance with the terms of this Trust Agreement."

The foregoing quoted provisions of the bond and the trust instrument clearly demonstrate that the liability of the Petitioner to pay the amount of the bonds is definite and fixed and if the bonds are not redeemed by the company prior to December 31, 1956, the Petitioner at that time must pay the principal and the interest due out of its available assets, regardless of the wishes or decision of its board of directors and regardless of whether it must impair its capital in order to make payment. Under these circumstances, the instruments are clearly bonds and not preferred stock.

In the case of *O. P. P. Holding Corporation*, 30 BTA 337, the Tax Court, at page 341, stated that the essential elements of a bond are: "A definite obligor; a definite obligee; a definitely ascertainable obligation; a time of maturity, either definite or that will become definite." Let us apply this definition of a bond to the instant case. The Petitioner is the definite obligor under the bond. It obligated itself to pay the amount as indicated by the bonds that were issued. The holders of the bonds are the definite obligees. They are entitled to demand and receive the principal amount of the bond and interest in accordance with the terms of the bond and the trust instrument under which they were issued. There is a definite ascertainable obligation to pay. Each bond states on its face the amount to which the payee is entitled when the bond matures. The time of maturity is absolutely definite. Unless sooner redeemed by the company in accordance with the terms of the trust instrument under which the bonds were issued, they will mature on December 31, 1956, and at that time the holders of any outstanding bonds will have the absolute right to demand payment and the Petitioner will have no recourse except to make payment to the full extent of its available property. It can

be seen, therefore, that the income debentures satisfy all of the requirements which the Tax Court in the O. P. P. Holding Corporation case stated must be present in order to constitute an instrument a bond.

Furthermore, in addition to the definite fixed date for the payment of the principal of the bond, plus interest in accordance with terms thereof, we find that the instruments are negotiable and are payable to bearer; that no assignment is required; no transfer is necessary on the books of the company or on the stock records; and that the interest becomes absolutely due if there are profits, without any action on the part of the board of directors to create the liability. In the case of stock, the holder thereof is entitled to receive dividends only in the event that the board of directors of the company decide to pay such dividends and it is only in the case of a showing of fraud that a court will assist the stockholders and compel the declaration of dividends. If the bonds in the instant case are not redeemed before December 31, 1956, the holders of the bonds at that time need not depend upon any discretion or decision by the Petitioner Corporation to receive payment on their bonds. The obligation to pay will then arise through lapse of time and unless payment is made, the holders of the bonds can successfully compel payment through court action. The foregoing characteristics are those of bonds rather than preferred stock.

The Petitioner could discuss many cases in which instruments in the form of bonds, and even instruments in the form of preferred stock, were held to create the relationship of "debtor and creditor," however, the factual situation in each case is so varied as compared to any given case, that it is believed such a discussion would unduly lengthen this brief. The case which seems to most nearly fit the facts in the instant case is that of *Commissioner* v. *H. P. Hood and Sons, Inc.*, 141 F. (2d) 467, decided by the Circuit Court of Appeals for the First Circuit.

In the Hood case, the Hood Company had outstanding preferred stock. In 1936 an issue of "7% income deben-

tures" was created and pursuant to a vote of the corporation, the debentures were offered in exchange on a par for par basis to the holders of the preferred stock. During the calendar years 1936 to 1940, inclusive, 29,498 shares of preferred stock of a par of $100 per share were exchanged for debentures. The company also sold $60,000 face amount of debentures for cash. The interest was payable quarterly, "only out of and to the extent of the net profits of the company." Any unpaid interest was cumulative. "The company reserved the right to issue other notes, debentures, bonds, or other obligations" in priority to the debentures. The Tax Court held that the debentures were bonds and that the company was entitled to deduct the interest paid thereon in arriving at taxable net income. The Commissioner appealed the case to the Circuit Court of Appeals for the First Circuit. The First Circuit sustained the Tax Court, and it is interesting to note that one of the principal authorities relied upon by the Circuit Court of Appeals in deciding that the instruments were bonds was the decision of the Tax Court in the case of *John Kelley Company*, 1 T. C. 457—the very case which is being argued in this brief. The Circuit Court pointed out that the subordination of the bondholders to the claims of other creditors was not fatal to the debenture holders' status as a creditor, and it also pointed out that it made no difference that the interest was payable "only out of and to the extent of the net earnings of the company." The only material difference in the facts in the Hood case as compared to the facts in the instant case is that unpaid interest was cumulative in the Hood case, whereas, in the instant case it is not. But this difference is not sufficient to cause the instruments in the Kelley case to fall within a different classification than those in the Hood case. Innumerable loans are made where no interest is provided for and where there is no intent that any interest will ever be paid, but, surely, this fact alone does not destroy the relationship of "debtor-creditor" between the parties. If the total absence of interest is insufficient to destroy the relationship of

"debtor-creditor" in a proper case, certainly, a provision for the payment of interest only in the event that certain conditions exist, would not have that result.

A further interesting observation may be made with respect to the Hood case. The Circuit Court stated that it was the type of case in which the decision of the Tax Court was final, in the light of the Dobson case. In this connection the Circuit Court said:

> "Since each case involving the question here presented must largely turn on its special facts, and since the Tax Court applied the correct rule of law, its determination is entitled to the finality indicated by *Dobson* v. *Helvering*, 320 U. S. — (1943)."

The Government did not apply for a writ of certiorari in the Hood case.

There remains one further question for discussion. At R. 57 and 58, the Circuit Court of Appeals emphasized the fact that the books of the corporation referred to the bonds "variously as 'stocks,' 'bonds' and 'notes,'" and that on the capital stock, income, and excess profits tax returns, the debentures were listed under "Capital Stock: Debenture Notes." The Tax Court found (R. 36) that even though the debentures were listed on the tax returns under heading "Capital Stock," nevertheless, the entry under this heading was "Debentures" and "Debenture Notes." The Commissioner of Internal Revenue was the one who took the affirmative in the introduction of evidence to show that in certain instances the books and records of the Petitioner referred to the debentures as "stock." In rebuttal, the Petitioner introduced evidence to show the instances in which its books and records referred to the debentures as "debentures," "bonds" and "notes." It is the position of the Petitioner that it makes no difference by what name or names the instrument, or the income arising therefrom, may have been recorded on the books and records of the Petitioner Corporation if such recordation is contrary to the actual facts.

It is now well settled in our income tax law that the method of recording a transaction on the books and records of a taxpayer, or the name which the taxpayer may assign to a given transaction, means nothing if the recorded entries and the names used are contrary to the essence of the transaction.

A thing is what its essence constitutes it to be and this essence is not changed by any name which the parties may use in recording the transaction on its books. In the case of *Doyle* v. *Mitchell*, 247 U. S. 179, this Court said:

> "Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which, in the present case, are not in dispute."

See also the cases of *Douglas* v. *Edwards*, 298 Fed. 229, and *United Profit-Sharing Corporation* v. *United States*, 66 Ct. Cls. 171. The Tax Court has announced the same principle in many cases and it would serve no purpose here in making a detailed reference to such decisions.

The same principle applies to the entries on the balance sheet attached to the capital stock, income and excess profits tax returns. As pointed out above, the debentures were listed on the returns under the heading "Capital Stock," nevertheless, the actual reference under this heading was to "debentures" and "debenture notes." The important point is that by entering the securities under the heading "Capital Stock" on the capital stock, income and excess profits tax returns, the Petitioner received no tax benefit, and its liability for taxes would have been exactly the same had the bonds been listed under "Liabilities" instead of under "Capital Stock." The Commissioner is not contending that the inclusion of the income debentures under the heading "Capital Stock" on the capital stock, income or excess profits tax returns resulted in a tax benefit to the Petitioner or

that the principle of estoppel should be applied. Under these circumstances, the entries made on the respective returns fall in the same category as the other book entries and they neither bind the government nor the taxpayer.

It is the position of the Petitioner that neither it nor the Respondent can get any consolation out of the fact that in certain instances the debentures were referred to on the books and records of the corporation variously as "stocks," "bonds" and "notes" and that the question must be decided on the basis of the instruments themselves and the method that was followed in their issuance. In addition to all that has been stated above, the testimony of Roy Kelley, Secretary and Treasurer of the Petitioner, concerning this point will be found at R. 14 and 15. Mr. Kelley testified that the confusion in the records was evidently caused by the different bookkeepers employed by the Petitioner who seemed "to call the debentures anything they wanted" and that the first time he knew of the discrepancies in the names used was when the revenue agent made his investigation in the fall of 1940 and called his attention to it. Of course, the record shows that the Tax Court took the above facts into consideration before reaching its conclusion that the instruments were bonds and not preferred stock (R. 36). See also the memorandum decision of the Tax Court in the case of *Charles Olson & Sons, Inc.*, Docket No. 109,980, reported at Par. 42,394 Prentice-Hall Memorandum Decisions Service 1942.

Wherefore, it is submitted that whether this case be considered from the standpoint of the principle of the Dobson case and related cases, or solely from the standpoint of the merits, the decision of the Tax Court was correct, and that the decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 36

THE JOHN KELLEY COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

To attempt to answer all of the arguments advanced by the Commissioner of Internal Revenue in his brief would be to argue the case again in the same manner that the argument was originally presented to the Tax Court. This Court has clearly announced that this may not be done. In the case of *W. G. Choate* v. *Commissioner*, 324 U. S. 1, this Court said:

> "In the second place, the Tax Court found that the parties intended a cash sale of the equipment. That question is argued here as if it were open for redetermination by us. It is not. It is the kind of issue reserved

for the Tax Court under *Dobson* v. *Commissioner*, 320 U. S. 489, and *Wilmington Company* v. *Helvering*, 316 U. S. 164, 167-168."

In view of the above admonition by this Court, the Petitioner shall not file the type of reply that would be in order if the case were now being argued before the Tax Court, but it shall confine itself to a discussion of the outstanding erroneous conclusions which the Respondent reaches in his brief.

At Page 31 of his brief, the Respondent argues that because the payment of interest on the bonds is conditioned upon the "net income" of the company being sufficient during any interest period to make the payment, the board of directors could deprive the bondholders of their interest by using the earnings of the company for plant expansion. Anyone who is as familiar with income taxes as is the Respondent, certainly knows that an investment in capital assets for the expansion of the business has no bearing on the determination of annual "net income." Under the terms of the debenture in this case, if the Petitioner has annual net income as determined in accordance with usual accounting principles, it has to pay the interest on the bonds and the directors of the corporation could not refuse to make the payment on the basis that the funds were to be invested in plant expansion.

In criticizing the decision of the Tax Court, the Respondent at Page 37 of his brief states that while the Tax Court listed the determining factors to be taken into consideration in a case of this type, "it did not indicate the weight to be ascribed to any factor." The findings of fact of the Tax Court (R. 33-39) show that the Tax Court took into consideration all of the facts which the Respondent contends are the ones that make the instrument a preferred stock, and after taking into consideration all of these facts, the Tax Court found that the instrument created the relationship of debtor and creditor. By so doing, the Tax Court performed its full duty in "weighing the evidence and choosing from

among conflicting factual inferences and conclusions those which it considered most reasonable." *Commissioner* v. *Scottish American Investment Company, Ltd.*, 323 U. S. 119. And in the Scottish American Investment Company case, this Court further said that after the Tax Court carries out this duty, "the Circuit Court of Appeals has no power to change or add to those findings of fact, or to reweigh the evidence." This is exactly what the Circuit Court of Appeals did in the instant case. It determined a transaction to be "all a matter of accounting hocus-pocus" in the face of a finding by the Tax Court that the transaction was bona fide and created the relationship of debtor and creditor. If this is not the changing of a finding of fact made by the Tax Court, then the Petitioner does not know what a finding of fact is. Furthermore, who ever heard of a legal principle which requires that the Tax Court in weighing the evidence and choosing from among conflicting factual inferences the conclusion which it considers most reasonable, must announce the percentage of the total weight which it gave to each of the various factors from which it drew its final conclusion? The Respondent does not, and cannot, cite any authority to support his argument that it is the duty of the Tax Court to follow such a procedure.

At Page 45 of his brief, the Respondent states that "the case is not one for the weighing of evidence and the resolution of testimonial differences, in which the Court below would have been bound by the facts as the Tax Court found them, but one for determination of the legal effect of the language, as contained in the uncontroverted agreements in writing." If the Respondent is relying solely on the language of the debenture at R. 17 and the trust indenture at R. 19, then he cannot hope to prevail for the reason that these instruments follow the general form of the bond and the trust indenture that is adopted in any case where a corporation issues debentures. But in other parts of his brief, the Respondent argues the collateral facts, and when he does so, he diverts from any legal principle that would

govern the case and causes the case to be one in which the ultimate conclusion is a question of fact.

At Page 49 of his brief, the Respondent makes the following statement: "The principle of the law involved is the meaning of the Statute, and to hold that the contract here constitutes an indebtedness will materially alter and expand in general the meaning of 'indebtedness' in the law." The Respondent makes this statement in the face of innumerable decisions holding that each case of this type "stands on its own feet." The Circuit Court of Appeals recognized this very principle when it said in its opinion, "each case stands on its own feet" (R. 56). Since no other case can "stand on the feet of this case," it naturally follows that a decision in favor of the Petitioner is not going to "materially alter and expand in general the meaning of 'indebtedness' in the law." As a matter of fact, it will not change the Statutory meaning of the word one iota.

The Respondent attempts to avoid the application of the principle of the *Dobson* and related cases by contending that a law question is presented, rather than an ultimate conclusion of fact to be drawn from the facts as found by the Tax Court. At Paragraph 13,004, et seq., of Prentice-Hall Federal Tax Service, there are listed the various cases that have been decided concerning the question as to whether a given instrument is a bond or a preferred stock. There are some sixty-five cases listed that have been decided by the Tax Court and the Circuit Courts of Appeals. If the theory of the Government in this case is correct, namely, that it presents a question of law, then the decided cases have established some sixty-five separate principles of law; yet, none of these sixty-five legal principles would be decisive of any future case, since all of the decided cases recognize the well established principle that each case of this type stands on its own feet. And because of this fact, the very legal principle for which the Respondent is contending should cause him to lose this case because of the further principle which this Court announced in the case of *Commissioner* v. *Scot-*

tish American Investment Company, Ltd., 323 U. S. 119, namely, that where a case does not establish a precedent that will govern other cases of the same general type, then the decision of the Tax Court in a particular case is final.

The Commissioner further argues that there is a question of law involved because the case turns on the meaning of the words "indebtedness" and "interest" as used in Section 23 (b) of the Code and Regulations. Neither the word "interest" nor the word "indebtedness" is defined in the Internal Revenue Code. The Regulations merely state that, "Interest paid or accrued within the year on indebtedness may be deducted from gross income" (Respondent's Brief, Page 3). The Regulations then state that, "So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income." The Petitioner heartily agrees with this statement. It is not arguing about the definition of the word "interest" or the word "indebtedness," since the meaning of these words in the business world and in the legal field is too well known to permit of any argument. The question in this case does not concern the meaning of the word "interest" or the word "indebtedness" as used in the law and the Regulations. The real question is whether, in the light of all of the facts, the relationship of debtor and creditor was created, and in the determination of this question, "the real intention of the parties is to be sought." *Commissioner* v. *Proctor Shop, Inc.*, 82 F. (2d) 792; *Commissioner v. Palmer, Stacy-Merrill, Inc.*, 111 F. (2d) 809; *Commissioner* v. *Richmond, Fredericksburg & Potomac R. R. Co.*, 90 F. (2d) 971; *Washmont Corporation* v. *Hendricksen*, 137 F. (2d) 306; and *John Wanamaker Philadelphia* v. *Commissioner*, 139 F. (2d) 644. The intention of the parties is a question of fact and not a question of law, and, therefore, the decision of the Tax Court in a case of this kind is final. It is because of this that the case of *Bingham's Trust* v. *Commissioner*, 325 U. S. —, 65 S. Ct. 1232, referred to by the Respondent at Pages 45 and 47 of his brief, does not apply. In the Bingham case,

there was involved a question of Statutory construction, whereas in the instant case, the application or the non-application of the Statute is automatic, once the basic question is decided, namely, was the relationship of debtor and creditor created.

At Page 50 of the Respondent's Brief, he discusses the case of *Deputy* v. *DuPont*, 308 U. S. 488. This case has no bearing on the instant case. In the DuPont case, this Court held that the amounts paid by DuPont which were equal to the dividends paid on stock with respect to which DuPont was "short" were not interest payments, for the reason that the basic facts of the case did not create the relationship of debtor and creditor between DuPont and the party to whom he was required to make the payments. But in the instant case, the Tax Court held that the debentures created the relationship of debtor and creditor, from which it follows that the amounts paid in connection with the instrument were interest payments.

The same thing holds true with respect to the case of *Equitable Society* v. *Commissioner*, 321 U. S. 560, discussed by the Respondent in his brief at Page 51. In that case, this Court pointed out that the stipulation filed by the parties was insufficient upon which to base a finding as to whether the relationship of debtor and creditor existed. This Court said that the findings of fact by the Tax Court did not go beyond the stipulation, "and it apparently was not asked to go further." This Court pointed out that "appropriate findings of fact might well bring such payments within the meaning of interest, as, for example, a finding that their declaration was the basis on which new contractual engagements were made." In the instant case, the Tax Court made the proper finding. It found that the debenture created the relationship of debtor and creditor, from which it naturally follows that the amounts paid as a result of this relationship were interest payments. The Respondent cannot cite any authority which holds that if the relationship of debtor and creditor exists, then the amounts paid because of that

relationship are anything other than interest. The Circuit Court of Appeals for the Fifth Circuit clearly stated the rule in the case of *Commissioner* v. *T. R. Miller Mill Co.*, 102 F. (2d) 599, wherein the Court said:

> "'There is no comprehensive rule by which the question of deductibility may be decided in all cases. Whether the payments involved represent interest on indebtedness *depends upon the relationship of the parties*. The fundamental consideration is whether the arrangement under which the taxpayer paid $30,000 each year to the trustees gave rise to the relationship of debtor and creditor. Commissioner of Internal Revenue v. Proctor Shop, Inc., 9th Cir., 82 F. (2d) 792." (Italics supplied.)

If we eliminate from the decision of the Circuit Court of Appeals all of the references concerning the bona fides of the transaction there is nothing left. At the bottom of Page 56 of the Record, the Circuit Court of Appeals referred to the fact that the officers of the corporation and the trustees under the trust instrument were the same persons, and it then said: "It was all a little arrangement between them. The same people represented both sides of the transaction. This is enough to inspire hesitation in calling it a bona fide trust agreement." The Court readily admitted that it intended to view the case from the standpoint of the bona fides of the transaction.

In the last paragraph at R. 56, and in the first paragraph at R. 57, the Circuit Court of Appeals refers to the transaction as a "scheme." At R. 58, the Circuit Court of Appeals said that while the name given to the document is not controlling, it may be persuasive if consistently used, "as indicative of the intent and purpose of the corporation issuing the document," but that if there has been inconsistent use of such name, "it may be considered in determining whether the corporation did what it professed to do." These statements clearly show that the Circuit Court of Appeals decided for itself what the *intent* of the parties was, regardless of the finding of the Tax Court on this point, and regard-

less of the admonitions of this Court in the *Dobson* case and the Scottish American case, both of which cases had been decided by this Court prior to the release of the opinion of the Circuit Court of Appeals in the instant case. We then come to the piece de resistance of the decision of the Circuit Court of Appeals. At Page 59 of the Record, the Circuit Court of Appeals said:

> "In short, it was all a matter of accounting hocus-pocus, guided by a little too clever legal planning which eventuated in a rather flimsy scheme to avoid payment of taxes. As far as we are concerned, it will not succeed."

In other words, the Circuit Court of Appeals, in effect, said that they did not care what this Court had said in the Dobson case and the Scottish American Investment Company case, nor did they care what finding the Tax Court made concerning the intent of the parties and the bona fides of the transaction; they were going to reweigh the evidence and draw therefrom their own conclusion of fact, namely, that the transaction was not bona fide, but was all a matter of accounting hocus-pocus. Webster, in his dictionary, defines "hocus-pocus" to mean: "A juggler's trick, sleight of hand, a cheat; hence, nonsense intended to cloak deception." The Tax Court had held that the transaction was bona fide, and that it created the relationship of debtor and creditor, but the Circuit Court of Appeals, by stating that it was all a matter of accounting hocus-pocus, held that it was a mere matter of sleight of hand; that by the transaction, the parties branded themselves as cheats and that it was all a matter of nonsense intended to cloak deception. The Petitioner submits that this was the purest kind of fact finding on the part of the Circuit Court of Appeals, and that since this finding is the direct opposite of the finding of the Tax Court, it must be rejected.

The brief of the Respondent is the type of brief that the Government filed when this case was pending in the Tax

Court. Its brief argues the case as though the ultimate question of fact is still in dispute before this Court. As the Petitioner has already pointed out, the decision of this Court in the case of *W. G. Choate* v. *Commissioner*, 324 U. S. 1, clearly shows that this question may not be argued before this Court. Although the brief of the Respondent is fifty-five pages long, it fails completely to comment on the point that is absolutely decisive of this case. At Page 10 of the original brief of the Petitioner, reference is made to the statement made by this Court in the case of *Commissioner* v. *Scottish American Investment Company, Ltd.*, 323 U. S. 119, in which this Court said that where a case is of the type that it "is of little value as precedent," then the decision of the Tax Court, for that reason alone, is final, and may not be reviewed by a Circuit Court of Appeals. At R. 56, the Circuit Court of Appeals, in speaking of the type of case with which we are now dealing, said: "Each case stands on its own feet." It is an utter impossibility to reconcile this statement by the Circuit Court of Appeals with the statement made by this Court in the Scottish American Investment Company case, and undoubtedly, it was because of this impossibility that the Respondent failed to make any attempt whatever to reconcile the statements. By admitting that the case "stands on its own feet," the Circuit Court of Appeals also admitted that the case cannot be used as a precedent in deciding other cases, with the result that this case falls squarely within the language which this Court used in the Scottish American Investment Company case.

WHEREFORE, it is submitted that the decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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No. 948

In the Supreme Court of the United States

OCTOBER TERM, 1944

THE JOHN KELLEY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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CITATIONS

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OPINIONS BELOW

The opinion of the Tax Court (R. 33–40) is reported at 1 T. C. 457; the opinion of the Circuit Court of Appeals (R. 55–59) is reported at 146 F. 2d 466.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 21, 1944. (R. 60.) The petition for a writ of certiorari was filed February 14, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether amounts paid by the petitioner corporation in the years 1937, 1938 and 1939 on its so-called eight per cent income debentures were deductible as interest on indebtedness within the meaning of Section 23 (b) of the Revenue Act of 1936 and identical provisions of the Revenue Act of 1938 and of the Internal Revenue Code, or were in reality non-deductible dividend distributions.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means

any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

Sections 23 (b) and 115 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code (26 U. S. C., Secs. 23 and 115) are identical with the above.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (b)–1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *.

* * * * *

* * * So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income. * * *

Article 23 (b)–1 of Regulations 101, promulgated under the Revenue Act of 1938, and Section 19.23 (b)–1 of Regulations 103, promulgated under the Internal Revenue Code, are identical with the above.

STATEMENT

The facts as stipulated and as found by the Tax Court may be stated as follows (R. 34–39):

Petitioner is an Indiana corporation, organized in 1907 and reorganized in 1930, and has its principal place of business in Marion, Indiana. It is engaged in the retail furniture business. Its income tax returns for the calendar years 1937, 1938, and 1939 were prepared from books kept on the accrual basis. The returns were filed with the Collector of Internal Revenue at Indianapolis, Indiana. (R. 34.)

On January 1, 1937, the petitioner had authorized as capital stock 1,500 shares of common stock at no par value and 3,000 shares of preferred stock at $100 par value, of which 1,110 shares of common stock and 1,124 shares of preferred stock had been issued and were outstanding. Roy F. Kelley, individually, owned 567 shares of common stock and 628 shares of preferred stock, and, as trustee for Mabel K. Ronald, he owned 543 shares of common stock and 496 shares of preferred stock; Mabel K. Ronald was a sister of Roy F. Kelley. (R. 34.)

During the month of January, 1937, Roy F. Kelley transferred the 628 shares of preferred stock and 171 of the common shares owned by him in his own right; 50 shares of preferred to Mabel K. Ronald, as trustee for her daughters, Ruth Stevens Korper and Mary Louise Stogsdill;

289 shares of preferred to Mabel K. Ronald as trustee for Ruth Stevens Korper; 289 shares of preferred to Mabel K. Ronald as trustee for Mary Louise Stogsdill; and the 171 shares of common stock to his wife, Birdena Kelley. It was provided in the above three trusts, however, that Birdena Kelley should receive the income from the 628 shares of preferred stock during her lifetime. (R. 34.)

On January 11, 1937, a special meeting of the board of directors of the petitioner corporation was held and a plan of recapitalization was adopted. Following that meeting, and on the same date, the shareholders of the corporation held a special meeting and approved the resolution adopted by the board of directors. Under this resolution the authorized issue of 1,500 shares of common stock of no par value was changed to 1,500 shares of common stock with a par value of $100 per share and then increased to 6,000 shares. The resolution also authorized the issue of "income debenture bonds" aggregating the sum of $250,000, bearing interest at the rate of eight per cent per annum, and the execution of a trust agreement setting forth the terms and conditions upon which the debenture bonds were issued and the power and duties of the trustees. Under the resolution the income debenture bonds would be offered by the trustees in exchange for the issued and outstanding 1,124 shares of the preferred

stock on the basis of $102 in face value of debentures for each share of the preferred stock; and, for the purpose of raising additional capital to expand the business of the corporation "in the field of finance," the trustees were to offer any and all unissued debenture bonds for sale at face value to the shareholders of the corporation. The directors' meeting was attended by the three directors, Mabel K. Ronald, Roy F. Kelley, and Mary Louise Stogsdill, and the holders of the entire capital stock of the corporation, Mabel K. Ronald and Roy F. Kelley, were present at the meeting of the shareholders. (R. 34–35.)

The trust indenture dated January 1, 1937, was entered into by the petitioner corporation through its president, Mabel K. Ronald, and secretary, Roy F. Kelley, with the trustees, Mabel K. Ronald and Roy F. Kelley. None of the income debenture bonds was issued prior to July 1, 1937. On that date Roy F. Kelley, as trustee for Mabel K. Ronald, delivered to the petitioner 496 shares of preferred stock, and simultaneously there were delivered to Roy F. Kelley, as trustee for Mabel K. Ronald, $50,592 face amount of the bonds. On the same date, Mabel K. Ronald, as trustee for Ruth Stevens Korper and Mary Louise Stogsdill, delivered to the petitioner 628 shares of preferred stock, and there were delivered to Mabel K. Ronald, as trustee for the same beneficiaries, $64,056 face amount of the income debenture

bonds. On July 1, 1937, Mabel K. Ronald and Birdena Kelley subscribed for $24,408 and $10,944, respectively, of the bonds. These amounts were carried against them in open accounts on the books of the petitioner and were later wiped out by the credit of dividends received by them on common stock. In the case of Mabel K. Ronald the dividends so credited were on the common stock held for her by Roy F. Kelley, as trustee, while in the case of Birdena Kelley the dividends were on the 171 shares of common stock which had been transferred to her by Roy F. Kelley in January of 1937. (R. 35.)

Petitioner, on December 10, 1937, filed articles of amendment of its articles of incorporation with the Secretary of State of Indiana, which showed the total number of shares of its capital stock to be 3,000 shares of preferred stock having a par value of $100 each and 6,000 shares of common stock having a par value of $100 each. (R. 35–36.)

On December 15, 1937, 1,110 outstanding shares of common stock of the petitioner were held as follows: 396 shares by Roy F. Kelley; 171 shares by Birdena Kelley; and 543 shares by Roy F. Kelley, as trustee for Mabel K. Ronald. A cash dividend of $55 per share was paid on 1,110 shares on December 15, 1937, after which a common stock dividend of 3½ shares for each share of common stock held was declared and paid by petitioner. (R. 36.)

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During the periods of July 1 to December 31, 1937; January 1 to December 30, 1938; and January 1 to December 31, 1939, the petitioner had outstanding "income debenture bonds" of the face amount of $150,000, in respect of which $6,000, $12,000, and $12,000 for each period, respectively, were set up on the books as accrued interest thereon. The amounts so accrued were paid and were claimed by petitioner as deductions in computing its taxable net income for the respective calendar years 1937, 1938, and 1939. These deductions were disallowed by the Commissioner. (R. 36.)

On the petitioner's books the "income debentures" were referred to as "stock", "bonds", and "notes". Charges were entered in an account which was headed "accrued interest, income debentures". In its capital stock tax returns for 1938 and 1939 it listed "debenture" and "debenture notes", respectively, as capital stock. They were not reflected as indebtedness in the balance sheets appearing in the income and excess profits tax returns filed by petitioner for 1937, 1938, and 1939, but appear under the heading "Capital Stock: Debenture Notes". The board of directors annually adopted corporate resolutions authorizing the payment of "interest" on the "income debenture bonds" or "debenture notes". On most of the checks, drawn for the "interest" on the "income debentures" to the

holders thereof, the nature of payment was described as "Interest, income debenture stock". (R. 36.)

On January 1, 1937, the assets of petitioner totaled $963,807.57 and its liabilities, exclusive of common and preferred stock, totaled $75,817.74. On December 31, 1937, its total assets were $982,221.08 and its total liabilities, exclusive of common stock and the debentures, were $46,158.19. (R. 36–37.)

The trust indenture set out the form of debenture to be issued, which was substantially followed, and the debentures in controversy read in part as follows (R. 37):

> THE JOHN KELLEY COMPANY, an Indiana corporation, for value received, promises to pay to the bearer on the 31st day of December, 1956, the sum of ONE THOUSAND DOLLARS ($1,000) in lawful money of the United States of America at the office of the Company in Marion, Indiana, and to pay interest thereon in like lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this Debenture for endorsement of payment thereon, conditioned, however, upon the net income of the Company being sufficient during any interest period to pay the amount due as interest, in accord with the

terms and provisions hereof. The interest on this Income Debenture shall not be cumulative.

* * * * *

If any of the events of default specified in the trust agreement shall occur, all debentures outstanding hereunder may be declared to be due and payable in the manner and with the effect provided in the trust agreement.

In the payment of their claims, all creditors, other than the stockholders of the Company, shall rank superior to the holders of this income debenture, but all holders of this income debenture shall rank pari passu with each other and superior to the stockholders of the corporation with respect to their share stock.

Article IV of the trust indenture set forth "Default and Remedies", and further provided (R. 37–38):

SECTION 1. If one or more of the following events of default happen, viz; (a) if default be made in the punctual payment of any installment of interest on any outstanding debenture or debentures or (b) if default be made in the observance or performance of any of the terms of said debentures or of this Trust Agreement, and any such last named default shall continue for a period of two (2) years after written notice thereof shall have been given to the Company by the Trustees (whose duty it

shall be to give such notice at the request in writing of at least twenty-five per cent (25%) in principal amount of the debentures at the time outstanding hereunder), then and in every such case, the Trustees may, and upon the written request of the holders of twenty-five per cent (25%) in principal amount of the debentures then outstanding hereunder shall declare the principal of all debentures then outstanding hereunder to be due and payable immediately, and upon any such declaration the same shall become immediately due and payable, anything in this Trust Agreement or in said debentures contained to the contrary notwithstanding.

The trust indenture provided certain procedure to be followed by the trustees and debenture holders in enforcing payment of the interest and principal, in case of default by the petitioner. In one provision the petitioner pledged that all of its property was free of mortgage and no lien or any other encumbrance would be placed upon it as long as any of the debentures were outstanding. It was also provided that the debentures were subordinate to the claims of petitioner's creditors but had priority over the claims of the stockholders. The holders of the debentures were not given the right to participate in the management of the business. (R. 39.)

The Commissioner disallowed the deductions claimed for interest paid in each of the taxable

years (R. 7–12) and determined deficiencies in income tax for the calendar years 1937, 1938, and 1939 in the amounts of $569.06, $1,980 and $1,980 respectively, and $360 in excess profits tax for the year 1937. (R. 33.) The Commissioner did, however, increase the dividends-paid credit by the amounts of $6,000, $12,000 and $12,000 in computing the petitioner's surtax on undistributed profits for the years involved. (R. 40.)

The Tax Court held that those amounts were deductible as interest paid on indebtedness (R 40) and determined that there were no deficiencies in taxes for the years in question (R. 41). On the Commissioner's petition for review, the Circuit Court of Appeals for the Seventh Circuit, holding in substance (R. 55–59) that the debentures clearly evidenced risk capital rather than creditor capital, reversed the Tax Court decision.

ARGUMENT

There is no occasion for further review of this case. The decision of the Circuit Court of Appeals is in accord with recent rulings of this Court; and no conflict among the circuits is presented.

1. The petitioner asserts that under *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231, and *Commissioner* v. *Scottish American Co.,* 323 U. S. 119, the Tax Court's disposition of this case should be accepted as final.

This contention, we believe, reflects a misconception of the character of error which the court below undertook to rectify. Section 23 (b) of the pertinent Acts, *supra,* allows deduction for "interest * * * on indebtedness". Article 23 (b) of Treasury Regulations 94, promulgated under the Revenue Act of 1936, *supra,* and the counterparts of that article under the Revenue Act of 1938 and the Internal Revenue Code, *supra,* declare negatively that—

> so-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted * * *.

Thus both statute and regulations contain two prerequisites to deductibility: the obligations on which the payments are made must constitute true "indebtedness", and the payments themselves must actually be "interest". See *Talbot Mills* v. *Commissioner* (C. C. A. 1st), decided December 22, 1944 (1945 C. C. H., par. 9122).

The opening sentence of the Tax Court opinion, however, stated (R. 39) the issue of the case at bar to be only—

> If the debentures have created an indebtedness the payments to the holders thereof are interest and deductible as expense, but if they are in fact capital stock the payments are dividends and not deductible.

Thus the Tax Court assumed as a matter of law that if the petitioner's "income debentures" evi-

dence "indebtedness" the payments made thereon were necessarily "interest"; and it was on that assumption of law that it held that they were. We think that such assumption was erroneous; and that our contention in the court below that it was erroneous raised an issue of law which that court was authorized to consider and pass upon. The question of what standards or criteria are laid down by statute is clearly one of law. *Powers* v. *Commissioner*, 312 U. S. 259, 260; *Helvering* v. *Amer. Dental Co.*, 318 U. S. 322, 330–331; *Dobson* v. *Commissioner*, 320 U. S. 489, 492–493; *Equitable Society* v. *Commissioner*, 321 U. S. 560; *Security Flour Mills Co.* v. *Commissioner*, 321 U. S. 281; *Dixie Pine Co.* v. *Commissioner*, 320 U. S. 516.

Particularly pertinent here is this Court's decision in *Equitable Society* v. *Commissioner*, *supra*, which was rendered subsequent to the Tax Court decision but prior to the decision of the court below. In the *Equitable* case, the Tax Court had denied a deduction claimed as "interest" paid on "indebtedness" within the meaning of Section 203 (a) (8) of the Revenue Act of 1932, defining the "net income" of life insurance companies. In reviewing the Circuit Court of Appeals' affirmance of the case, this Court itself determined, on the basis of the stipulated facts and the provisions of the relevant insurance policies, whether the "excess interest dividends" there involved were "interest" within the meaning of the stat-

ute;[1] it held that they were not. By parity of reasoning, it would appear that the Circuit Court of Appeals in this case was authorized to determine, on the basis of the stipulated facts and the provisions of the instruments here, whether the Tax Court had erred in holding (1) that the obligations at bar constituted "indebtedness" within the meaning of the statute, and (2) that it followed as a matter of course that the payments in question were "interest" within Section 23 (b).

This Court recently reviewed a decision of a Circuit Court of Appeals reversing the Tax Court on the question whether compensation for personal services was realized upon the exercise of a stock option. *Commissioner* v. *John H. Smith, No.* 371, decided February 26, 1945. While disapproving the result reached by the Circuit Court of Appeals, it was recognized that a reviewable question was presented because—

> the Tax Court concluded as a matter of law that the facts which it found * * * brought the case, for the tax year 1938, within the provisions of Section 22 (a) of the Revenue Act of 1938, and of the interpretative Treasury Regulations 101, Art. 22 (a)–1; * * *

Similarly, in reviewing the Tax Court's decision that the payments in question come within the

[1] The case did not present the question of whether the obligations themselves were "indebtedness."

scope of Section 23 (b) and the interpretative regulation, the Circuit Court of Appeals in the present case was not invading the province of the Tax Court. It was merely inquiring whether the Tax Court had correctly applied the law to the facts which it had found.[2]

2. So far as the merits are concerned, we submit that the decision of the court below was correct. In passing upon the question of whether the petitioner's "income debentures" evidenced "indebtedness", the Tax Court seems to have fallen into error in applying the mandate of the regulations that the obligation upon which the payments are made shall not, in actuality, be preferred stock. Examination of the instruments at

[2] The petitioner contends (Br. 9) that the court below "refused to recognize a finding of fact made by the Tax Court, namely, that the issuance of the bonds was a bona fide transaction"; and that the appellate court "made its own finding of fact, namely, that the transaction was 'all a matter of accounting hocus-pocus' (R. 59), which finding is the direct opposite of the finding made by the Tax Court." Petitioner further states (Br. 9) that the Circuit Court of Appeals decision "is based squarely on the aforesaid finding of fact made by it." However, the Tax Court made no finding with respect to the bona fides of the transaction; and while the court below did state (R. 59) that the conversion from stock to so-called income debentures was "all a matter of accounting hocus-pocus," that was not the basis of its decision. Reversal was grounded on the statement preceding the one to which petitioner refers, namely (R. 59): "Such debentures obviously evidenced risk capital, not creditor capital." The question is not one of motivation; it is one of accomplishment. Cf. *Gregory* v. *Helvering*, 293 U. S. 465.

bar shows that these obligations had every aspect of preferred stock and none of the aspects of debt except one[8]—they had a fixed maturity date. But as the court below pointed out (R. 58), it is not uncommon today for preferred stock to carry a retirement date; in fact such is expressly authorized by petitioner's domiciliary law. Petitioner's 1937 "conversion" from stock to indentures was manifestly nothing more than a *pro forma* change; in reality, the pre-conversion proprietary interests of the holders continued unaltered.

Furthermore, as we have previously noted, even on the assumption that the Tax Court was correct in holding these obligations constitute "indebtedness" as to principal, it does not follow, as the Tax Court thought, that the payments in question satisfied the statutory concept of "interest". The opinion of the Circuit Court of Appeals plainly reveals the non-sequitur in the Tax Court's reasoning.

In *Deputy* v. *duPont*, 308 U. S. 488, 498, this Court defined interest as "compensation for the use or forebearance of money". The Tax Court did not find that there was any "use or forebearance of money" in the instant case; and it is evi-

[8] It is true that the instruments themselves were formally denominated "Income Debentures", but as the Tax Court found (R. 36), they were more often referred to, and treated by petitioner, as stock.

dent from the facts which it did find (R. 34–36) that there was none. Furthermore, in the *Equitable* case, *supra,* this Court pointed out that the concept of "interest" does not embrace amounts payable upon a contingency; and here, as the critical instruments unequivocally recite (R. 37), the so-called "interest" was not cumulative and never became payable unless there were earnings during each annual period.[4] And, as this Court also observed in the *Equitable* case (p. 564), it is not material that the contingency to payment—here the sufficiency of earnings—may have happened.[5]

---

[4] This serves to distinguish *Commissioner* v. *H. P. Hood & Sons*, 141 F. 2d 467 (C. C. A. 1st), upon which petitioner relies (Br. Point 3) as creating a conflict. In the *Hood* case, the Circuit Court of Appeals construed the pertinent contracts as providing that interest was in all events collectible at the maturity date of the principal. In the *Hood* case, too, a certain amount of the obligations were sold for cash. Moreover as concerns the question of whether the obligations were "indebtedness," the *Hood* holders, unlike the holders at bar (R. 37), ranked *pari passu* with general creditors.

[5] It is true that the contingency involved in the *Equitable* case was a different contingency from the one concerned in the case at bar; there the "excess interest dividends" were payable at the discretion of the taxpayer's directors, whereas here the "liability" was not of a discretionary character. But the *Equitable* opinion indicates that if it had been clear that the payments were conditional upon earnings, the decision might have been rested on that ground also; in any event, whether discretionary or not, liability here was certainly conditional, for unless and until there were earnings, no "interest" was due.

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted,

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No. 36

In the Supreme Court of the United States

OCTOBER TERM, 1945

THE JOHN KELLEY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Tax Court (R. 33–40) is reported at 1 T. C. 457; the opinion of the Circuit Court of Appeals (R. 55–59) is reported at 146 F. 2d 466.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 21, 1944. (R. 60.) The petition for a writ of certiorari was filed February 14, 1944, and was granted April 30, 1945. (R. 61.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether taxpayer-corporation was entitled to deduct as "interest" on "indebtedness" within the meaning of Section 23 (b) of the Revenue Act of 1936 and identical provisions of the Revenue Act of 1938 and the Internal Revenue Code, payments made during the taxable years to holders of its so-called "20 Year 8% Income Debenture".

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 193[illegible], c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.
>
> * * * * *
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
> (a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money

> or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> * * * * *

Sections 23 (b) and 115 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code (26 U. S. C. 1940 ed., Secs. 23 and 115) are identical with the above.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 23 (b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *.
>
> * * * * *
>
> * * * So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income.

Article 23 (b)-1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938 and Section 19.23 (b)-1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, are identical with the above.

STATEMENT

Substantially all the facts were stipulated. (R. 33.) Others not stipulated were found by the Tax

Court from the record made at the hearing before it. (R. 34.)

Taxpayer is an Indiana corporation, organized in 1907, reorganized in 1930, operating a retail furniture store in Marion, Indiana. (R. 34.) The taxable years involved are the calendar years 1937, 1938, 1939; the returns were prepared on the accrual basis. (R. 34.) On January 1, 1937, the authorized capital stock of taxpayer consisted of 1,500 shares of common, no par value, and 3,000 shares of 6% preferred stock, $100 par value (R. 31); 1,110 shares of the common stock and 1,124 shares of the preferred stock were issued and outstanding and all of the outstanding stock, both common and preferred, was owned by Roy Kelley, individually and as trustee for his sister, Mabel Ronald (R. 34). During the month of January, 1937, Roy Kelley transferred the preferred stock owned by him individually (628 shares) to Mabel Ronald as trustee for her daughters, providing, however, that his wife, Birdena, should receive the income from this preferred stock during her lifetime. (R. 34.) In addition, he transferred outright some of the common stock owned by him individually (171 out of 567 shares) to his wife, Birdena. (R. 34, 36.) Mabel Ronald was president of the company and Roy Kelley was secretary, and they, plus Mrs. Ronald's daughter, Mary Louise Stogsdill, constituted its board of directors. (R. 35.)

On January 11, 1937, at a special meeting of this board of directors a plan of recapitalization

of taxpayer was adopted which was approved on the same day at a special meeting of the shareholders (Mabel Ronald and Roy Kelley). (R. 34–35.) The corporate resolution, thus adopted, provided for the following (R. 34–35):

> The change and increase of the 1,500 shares of no par common stock to 6,000 shares of $100 par value;
>
> The issuance of "income debenture bonds" aggregating the sum of $250,000, bearing 8% interest;
>
> The execution of a trust agreement setting forth the terms and conditions upon which the income debentures were to be issued and the duties and powers of the trustees;
>
> The offer of the new securities by the trustees in exchange for all the issued and outstanding 6% preferred stock, on the basis of $102 face value of the income debentures for each share of preferred stock;
>
> For the purpose of raising additional capital to expand the corporate business "in the field of finance", the sale by the trustees of additional debentures at par but only to the shareholders of taxpayer.

The resolution was executed in the following manner:

The trust indenture, as drawn, was dated back to January 1, 1937. (R. 35; Exhibit "F", R. 19–30.) The brother and sister, Mabel Ronald and Roy Kelley, were appointed and signed as trustees, and the same individuals, in their official capacity as president and secretary, respectively, signed on

behalf of taxpayer. (R. 30, 35.) None of the new securities were issued prior to July 1, 1937. On that date, the total outstanding 1,124 preferred shares then owned, as already noted, by Roy Kelley as trustee for his sister, Mabel Ronald (628 shares), and by Mabel, in turn, as trustee for her daughters (496 shares), were delivered to taxpayer in exchange for income debentures in the amount of $114,648. On the same date, Mabel Ronald and Roy Kelley's wife, Birdena, subscribed, respectively, for $24,408 and $10,944 of income debentures. However, these sums were not paid in cash but were carried as open accounts on the books of the corporation. Subsequently they were balanced by a credit of dividends paid by taxpayer on the common stock owned by them.[1] (R. 35.) Thus, the total income debentures issued aggregated $150,000 in face amount. (R. 36.)

On January 1, 1937, taxpayer's assets totaled $963,807.57 and its liabilities, exclusive of common and preferred stock, totaled $75,817.74. On December 31, 1937, its total assets were $982,221.08 and its total liabilities, exclusive of common stock and the debentures, were $46,158.19. (R. 36–37.)

[1] In the case of Mabel Ronald, the dividend was credited on the common stock held for her by Roy Kelley as trustee; in the case of Birdena Kelley, the dividend was on the 171 shares of common stock, which, as already noted, had been transferred to her by her husband on January 1, 1937. (R. 35.) The dividend was apparently paid on December 15, 1937, being $55 in cash and a stock dividend of 3½ shares. (R. 36.)

On taxpayer's books the "income debentures" were referred to as "stocks," "bonds," and "notes." Charges were entered in an account which was headed "accrued interest, income debentures." In its capital stock tax returns for 1938 and 1939, taxpayer listed "debenture" and "debenture notes," respectively, as capital stock. They were not reflected as indebtedness in the balance sheets appearing in the income and excess profits tax returns filed by taxpayer for 1937, 1938, and 1939, but appear under the heading "Capital Stock: Debenture Notes." Annual corporate resolutions were adopted authorizing the payment of "interest" on the "income debenture bonds" or "debenture notes." On most of the checks drawn for the "interest" on the "income debentures", the nature of the payment was described to be for "Interest, income debenture stock." (R. 36.)

The form of the debentures, insofar as material, was as follows (R. 17–18, Ex. "E"):

THE JOHN KELLEY COMPANY

20 YEAR 8% INCOME DEBENTURE

The John Kelley Company, an Indiana corporation, for value received, promises to pay to the bearer on the 31st day of December, 1956, the sum of

One Thousand Dollars ($1,000)

in lawful money of the United States of America at the office of the Company in

Marion, Indiana, and to pay interest thereon in like lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this Debenture for endorsement of payment thereon, conditioned, however, upon the net income of the Company being sufficient during any interest period to pay the amount due as interest, in accord with the terms and provisions hereof. The interest on this Income Debenture shall not be cumulative.

This debenture bond is * * * entitled to all the benefits specified in a trust agreement dated January 1, 1937, made by and between The John Kelley Company and Mabel K. Ronald and Roy F. Kelley, as Trustees, to which trust agreement reference is hereby made for a description of the rights of the holders of such debentures, and of the Trustees with respect to the enforcement thereof.

This debenture may be redeemed at the option of the Company on any interest date prior to maturity upon notice in the manner and upon the terms provided in the trust agreement by payment of its principal amount and accrued interest to the date of redemption; after such redemption date, interest on the debentures called for redemption shall cease unless payment thereof shall be refused after presentation. All debentures purchased or redeemed by the Trustees shall be cancelled and not reissued.

If any of the events of default specified in the trust agreement shall occur, all debentures outstanding hereunder may be declared to be due and payable in the manner and with the effect provided in the trust agreement.

In the payment of their claims, all creditors, other than the stockholders of the Company, shall rank superior to the holders of this income debenture, but all holders of this income debenture shall rank pari passu with each other and superior to the stockholders of the corporation with respect to their share stock.

* * * * *

Additional provisions contained in the trust agreement, so far as pertinent, were as follows (R. 23, 24–25, 27–28):

ARTICLE II.

COVENANTS OF THE COMPANY.

* * * * *

SECTION 2. The Company covenants that there are no liens or encumbrances on its real or personal property, and that so long as any of the debentures issued hereunder are outstanding the Company will not mortgage, pledge, or otherwise encumber any of its real or personal property owned at the date hereof or hereafter acquired.

SECTION 3. The Company covenants that so long as any of the debentures issued hereunder are outstanding, it will at all times keep all its buildings, plants, equipment, merchandise and fixtures and other

insurable property properly insured against loss or damage by fire to the extent that such property is usually insured by companies operating retail stores and properties of a similar character.

SECTION 4. The Company covenants that so long as any of the debentures issued hereunder are outstanding it will pay to the holders thereof the full amount of interest stipulated to be paid therein before it shall declare a dividend to the holders of the common stock of the Company.

* * * * * * *

ARTICLE IV.

DEFAULT AND REMEDIES.

SECTION 1. If one or more of the following events of default happen, viz.: (a) if default be made in the punctual payment of any installment of interest on any outstanding debenture or debentures or (b) if default be made in the observance or performance of any of the terms of said debentures or of this Trust Agreement, and any such last named default shall continue for a period of two (2) years after written notice thereof shall have been given to the Company by the Trustees (whose duty it shall be to give such notice at the request in writing of at least twenty-five per cent (25%) in principal amount of the debentures at the time outstanding hereunder), then and in every such case, the Trustees may, and upon the written request of the holders of twenty-five per cent (25%) in

principal amount of the debentures then outstanding hereunder shall declare the principal of all debentures then outstanding hereunder to be due and payable immediately, and upon any such declaration the same shall become immediately due and payable, anything in this Trust Agreement or in said debentures contained to the contrary notwithstanding.

This provision, however, is subject to the conditions that if at any time after the principal of said debentures shall have been so declared due and payable, and before any judgment or decree for the payment of monies due shall have been entered, all arrears of interest upon all the debentures shall have been duly paid and all defaults shall have been made good, and all the stipulations of said debentures and of this Trust Agreement shall have been fully performed by the Company, then, and in every such case, the holders of a majority in principal amount of the debentures then outstanding, by written notice to the Company and to the Trustees, may waive such default and its consequence and rescind such declaration; but no such waiver of rescission shall extend to or affect any subsequent default or impair any right consequent thereon.

SECTION 2. The company covenants that (a) in case default shall be made in the punctual payment of any installment of interest on any outstanding debenture or debentures and such default shall have continued for a period of two (2) years;

or (b) in case default shall be made in the payment of the principal of any such debenture or debentures when the same shall become payable, whether upon maturity or upon call or declaration as provided in this Trust Agreement, then upon demand of the Trustees the Company will pay to the Trustees for the benefit of the holders of the debentures issued hereunder and then outstanding, the whole amount which then shall have become due and payable on all such debentures then outstanding and in addition thereto such further amount as shall be sufficient to cover the costs and expenses of collection, including a reasonable compensation to the Trustees, their agents, attorneys and counsel, and any expenses or liability incurred by the Trustees hereunder. In case the Company shall fail forthwith to pay such amount on such demand, the Trustees in their own names and as Trustees of an express trust shall be entitled and empowered to institute such action or proceeding at law or in equity, as may be advised by counsel, for the collection of the sums so due and unpaid and may prosecute any such action or proceeding to judgment or final decree and may enforce any such judgment or decree in the manner provided by law.

* * * * *

SECTION 5. No holder of any income debenture issued hereunder shall have the right to institute any action or proceeding in equity or at law upon said debenture or debentures, or for the enforcement of any

of the terms of this Trust Agreement, unless and until such holder shall have previously given to the Trustees written notice of a default of the Company in the performance of one or more of the stipulations of said debentures or of this Trust Agreement and its continuance as hereinbefore provided, and also unless or until the holders of twenty-five per cent (25%) (or in case of the prohibitions or negative covenants hereof, the holders of 10% as hereinabove provided) in principal amount of the debentures outstanding shall have made written request of the Trustees and shall have offered to said Trustees indemnity to their satisfaction against the costs, expenses and liabilities to be incurred by said Trustees, and shall have afforded to the Trustees a reasonable opportunity to exercise the powers herein granted to enforce this Trust Agreement, and the Trustees shall have refused or unreasonably delayed to comply with such request.

Provided, however, that nothing in this Trust Agreement shall affect or impair the obligation of the Company, which is unconditional and absolute, to pay at the date of maturity therein expressed the principal of the debentures to the respective holders thereof, or affect or impair the right of action of such holders to enforce such payment, subject only to the prior right of the Trustees, if exercised promptly in accordance with the terms of this Trust Agreement.

The debenture holders had no right to participate in the management of the business. (R. 39.)

The preferred stock for which the debentures had been exchanged provided that it should have as against the common stock a first lien on the assets of the corporation, subject to the rights of creditors, and entitled each year out of surplus and net profits to "a fixed dividend" of 6% payable semiannually on the first days of January and July, before common stock dividends. (R. 31.). The preferred stock dividends were cumulative. In the event of liquidation, assets were first to be applied to the claims of creditors, then to preferred stockholders at par and accumulated dividends, before the common stock. At the option of the company the preferred stock might be redeemed or retired at any dividend period at $102 per share, together with unpaid dividends. (R. 31–32, Ex. "G".)

Taxpayer claimed in its income tax returns for the years 1937, 1938, and 1939, as interest deductions upon the aggregate face amount of $150,000, payments made to debenture holders of $6,000, $12,000, and $12,000, respectively. The Commissioner disallowed these deductions. (R. 36.) The Tax Court overruled the Commissioner (R. 39–40), and the court below, reversing the Tax Court, sustained the Commissioner (R. 55–59).

SUMMARY OF ARGUMENT

I

A. By Section 23 (b), Congress has granted a deduction for "interest" paid on an "indebtedness" in order to permit a subtraction from gross income of a fixed and definite charge on the taxpayer's operations which often may constitute a cost, certain in character, incurred in the earning of income. But the legislative history, the statutes and the Regulations having the force of law make it clear that a deduction is not allowable for earnings and profits distributed by a taxpayer corporation to the proprietors of its business. The legislative history establishes that since the inception of the income tax, Congress and the Treasury have recognized the potentiality for misapplication of the interest deduction through masquerade of dividends distributed on preferred stock in the guise of interest payments on indebtedness, and have steadfastly manifested the intent to preclude such a construction. Furthermore, interest like other deductions, being a matter of legislative grace, does not turn upon general equitable considerations; only if there is clear provision therefor may the deduction be allowed. The rule of construction is strict, and the burden is upon the taxpayer of proving that there was an "indebtedness" and that "interest" was paid upon it.

B. The terms of the contract do not require the payment of interest nor give rise to an indebted-

ness. Every provision of these "debentures" is familiar to preferred stock. The name borne by the certificates is of little importance. The substantial legal rights and duties, which the agreement creates, are the determining factors and the misuse of words cannot change the legal conclusions which follow from these rights and obligations.

The income feature bears a close resemblance to capital stock. These payments, like dividends, are limited to a distribution of net corporate earnings or profits during a given year, and are not cumulative. Should there be no net income for a given annual period, no claim for payments survives, and neither may it be asserted at the time of the alleged "maturity" of the security. Again, as in the case of dividends, the distribution is essentially dependent upon the directors' discretion, and the instant agreement, as security for the payment of interest, is actually no more than the pledge of the good faith of the company in managing its business. Similarly, as with dividends, the exercise of the directors' discretion, as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation, and other reserves, and what balance remains as net income for distribution to holders of these securities, is unlimited in the absence of bad faith, and a mistake of judgment will afford no ground of complaint. Essentially, a certificate holder here, like a stockholder, is merely

an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no return upon his money whatsoever. The long continued Treasury Regulations, denying a deduction of "so-called interest on preferred stock, which is in reality a dividend thereon", are here clearly applicable.

Again, it is immaterial that the contract did not authorize the certificate holders to participate in management, or that it contains an agreement against future encumbrance of the corporate property. Such provisions are common in the case of preferred stock. On the other hand, the covenant in the trust indenture that, so long as any of the debentures are outstanding, taxpayer will pay the holders the full amount of "interest" before declaring a dividend to common stockholders, possesses significance only if the certificates create the rights and obligations of preferred stock. If the certificates actually constitute indebtedness, as taxpayer claims, no such protection is required, for the obligation to pay net income is then absolute, irrespective of dividend declarations.

Finally, a right to repayment of investment at a definite time is a proper and not uncommon provision of preferred stock, always subject, as here, to the rights of creditors. Thus, the certificate holders are here again precisely in the position of preferred stockholders, since at maturity they

rank inferior to all creditors, superior only to other stockholders. If misfortune overtakes the company, their investment is subject to the payment of every debt. Besides, the remedies afforded the certificate holders in the event of default, do not differ materially from those frequently accorded to preferred stockholders. In any case, no default can occur in the payment of "interest", unless the directors in the exercise of managerial discretion permit income to remain unexpended at the end of a given annual period; hence, the possibility of default is dependent upon the taxpayer's discretion and good faith, and the certificate holders' rights are not absolute, as in the case of a debt. Thus, viewing the transaction from any angle, it has all the aspects of preferred stock.

C. In its opinion the Tax Court listed what it termed "the determining factors" (R. 40), and then proceeded to apply them. It did not indicate the weight to be ascribed to any factor. It disposed of factors which would have supported a conclusion contrary to that which it reached by the simple statement that each in itself was not decisive. It failed to list and take into account other factors with respect to which it had made findings of fact and which the court below believed to be important. Its conclusion was not substantially supported by any factor. The Circuit Court of Appeals did not undertake to weigh the factors which the Tax Court relied upon. The

method which the Tax Court here expressly employed in testing its fact findings establishes that its conclusion is arbitrary and amply justifies reversal by the court below. The court below in no way controverted the fact findings of the Tax Court; on the contrary, it made the only holding based on the Tax Court's findings which is legally sufficient, namely, a holding that the transaction did not involve the payment of genuine interest on genuine indebtedness. Where, as here, the record is destitute of evidence to support a finding—the taxpayer having the burden—it was the duty of the reviewing court to reverse an order resting upon such a finding.

D. Moreover, the Government not only contends that the court below properly reversed the Tax Court, since its treatment of the uncontroverted facts was arbitrary, but further urges whether the agreement creates "indebtedness" within the meaning of the statute, is a question of law which the court below rightly decided. The terms of the agreement, as found by the Tax Court, are not challenged. The question whether the contract obligated the payment of "indebtedness" turns on the meaning of these words as used in the statute and is consequently a question of law. The case therefore depends upon the legal effect of language, as contained in uncontroverted written agreements, which has repeatedly been held to be a question of law subject to appellate review. Moreover, here Congress has incorpo-

rated familiar common law conceptions of contract and property law into the Revenue Act, with respect to which the Tax Court has no special competence. In any event, this Court has frequently re-examined, as matters of law, determinations by the Tax Court of the meaning of the words of the statute as applied to facts found by that tribunal. While it is true that no two agreements are exactly alike, the controversy here does not therefore become factual. The principle of law involved is the meaning of the statute, and to hold that the contract constitutes an "indebtedness" will materially alter and expand in general application the meaning of "indebtedness" in the statute.

II

Furthermore, the contract does not, as a matter of law, require the payment of "interest". Thus, even assuming *arguendo* that these certificates represent an "indebtedness", payments of this uncertain, indefinite and discretionary character limited to corporate earnings cannot as a matter of law constitute "interest" within the meaning of the statute. It is not enough for taxpayer to establish that an "indebtedness" exists and that a sum, which is not "interest", has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon it to establish that it has paid strictly "interest". Congress has allowed a deduction only of "in-

terest" and proof that the payment is "interest" remains the primary prescription of the statute. These payments which are contingent upon (a) the existence of earnings; (b) their existence during a given calendar year, and (c) exercise of managerial discretion by the directors substantially as broad as that which exists in the case of dividends on stock, have a degree of uncertainty which the notion of interest ordinarily lacks. Certainly they do not satisfy a strict rule of construction, and Congress intended strictly "interest" to be deducted and nothing else. The question is one of law, namely, whether on the basis of the agreement the income payments sought to be deducted were "interest" within the meaning of the revenue acts. The principle of law involved is the meaning of the statute; to include the payments in the instant case, contingent upon the existence of earnings during a given calendar year and upon the exercise of a broad managerial discretion by directors, will in general radically alter and expand the meaning of interest in all applications.

ARGUMENT

I

THE COURT BELOW PROPERLY REVERSED THE HOLDING OF THE TAX COURT, SINCE, VIEWING THE TRANSACTION FROM ANY ANGLE, IT HAS ALL THE ASPECTS OF AN ISSUE OF RESTRICTED PREFERRED STOCK

A. The statutes involved and Regulations having the force of law, exclude, as interest deductions, distributions of earnings and profits to stockholders

The statutes involved permit deductions of "all interest paid or accrued within the taxable year on indebtedness". (Section 23 (b), Revenue Acts of 1936 and 1938 and Internal Revenue Code, *supra*, p. 2.) This language is to be found substantially unchanged in successive revenue acts for many preceding years beginning (as applying to corporations) with the Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 234 (a) (2). Previously the Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, Section 38, Second, had limited the deduction to—

> interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, * * *.

The Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Section II G (b), contained a similar provision, as also did the Revenue Act of 1916, c. 463, 39 Stat. 756, Section 12 (a), Third. These early limitations upon the privilege of interest deductions by corporations were explained on the

floor of Congress, during the debate in the House on the 1916 Act (53 Cong. Record, Part II, p. 10656) as follows:[2]

> the original theory of the matter was that corporations could issue quite a lot of watered stock, transfer that into bonds, mortgage their property, and incur interest, and make a great many shifts in many ways that would result in avoiding the real purpose of the law. This bill allows them to deduct interest on an amount of indebtedness double their capital stock.

The 1916 Act contained further an express provision (Section 12 (a), Third):

> That for the purpose of this title preferred capital stock shall not be considered interest-bearing indebtedness, and interest or dividends paid upon this stock shall not be deductible from gross income * * *.

The Treasury Regulations promulgated under this Act (Treasury Regulations 33 (Revised), Art. 185) first contained the provision:

> So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at the net income.

This regulation was repeated in Treasury Regulations 45, under the Revenue Act of 1918, Article 564, where, as noted above, the general language of the statute, so far as pertinent, is the same as

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[2] This explanation was made by a member of the Committee on Ways and Means, Mr. Hull.

that contained in the Revenue Acts presently involved. Moreover, the quoted regulation has been continued without substantial change up to the present time. (Article 23 (b)–1 of Regulations 94 and 101 and Section 19.23 (b)–1 of Regulations 103, *supra*, p. 3.) On familiar principles Treasury Regulations, long continued without substantial change, are deemed to have received Congressional approval and have the force of law. *Taft* v. *Commissioner*, 304 U. S. 351, 357; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Douglas* v. *Commissioner*, 322 U. S. 275, 281–282; *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. 2d 815, 817 (C. C. A. 9th), certiorari denied, 317 U. S. 663.

Moreover, this legislative history further establishes that substantially during the entire history of the income tax, Congress and the Treasury have recognized the potentiality for misapplication of the interest deduction through masquerade of dividends distributed on preferred stock in the guise of interest payments on indebtedness, and have steadfastly manifested the intent to preclude such a construction. Indeed, this distinction is fundamental, for its basis is seen in the very principle upon which the interest deduction is founded. In the exercise of legislative grace, Congress has granted the interest deduction in order to permit a subtraction from gross income of a fixed and definite charge on the taxpayer's operations, which often may constitute a cost, certain in character, incurred in the earning of income. Clearly, on

the other hand, the legislative history, the statutes and the Regulations, having the force of law make it clear that the interest deduction is not applicable to mere distributions of exclusion of deductions for earnings and profits distributed by a taxpayer corporation to the proprietors of its business. Such distributions the relevant statutes define as dividends (Section 115 (a) of the Revenue Acts of 1936 and 1938 and Internal Revenue Code, *supra*, p. 2):

> *Definition of Dividend.*—The term "dividend" * * * means any distribution made by a corporation to its shareholders, * * * out of its earnings or profits. * * *.

Furthermore, interest like other deductions is a matter of legislative grace. The rule of construction is strict. It does not turn upon general equitable considerations; only if there is clear provision therefor can any particular deduction be allowed. *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564; *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *Deputy* v. *duPont*, 308 U. S. 488, 493; *Brown-Rogers-Dixson Co.* v. *Commissioner*, 122 F. 2d 347, 350 (C. C. A. 4th). The burden is upon the taxpayer of showing that the deduction claimed clearly falls within the terms of the statute, and, thus, includes the burden of proving that there was an "indebtedness" and that "interest" was paid upon it. *Commissioner* v. *Drovers Journal Pub. Co.*, 135 F. 2d 276, 278, 279 (C. C. A. 7th).

B. Every provision of these "debentures" is characteristic of or familiar to preferred stock

Viewing the agreements involved the question is, do their provisions create an "indebtedness" and prescribe the payment of "interest"? Here, as the court below rightly held (R. 59):

> Every provision of these debentures is a frequent and authorized clause familiar to preferred stock.

True, the nomenclature employed is that of debt, the instrument is called a "20 Year 8% Income Debenture" or a "debenture bond". (R. 17.) Taxpayer "promises to pay" the principal sum "and to pay interest". (R. 17.) However, it is well settled that (*In re Fechheimer Fishel Co.*, 212 Fed. 357, 360 (C. C. A. 2d), certiorari denied, *sub nom. Dellevie* v. *Fechheimer-Fishel Co.*, 234 U. S. 760)—

> the fact that an instrument is called a "bond" is not conclusive as to its character. It is necessary to disregard nomenclature and look to the substance of the thing itself.

The substantial legal rights and duties which the agreement creates are the determining factors. The misuse of words of art cannot change the legal conclusions which follow from these rights and obligations. *Bakers' Mutual Coop. Ass'n* v. *Commissioner*, 117 F. 2d 27, 28 (C. C. A. 3d). If an instrument is described as a bond and it is not a bond but preferred stock, and if payments are referred to as interest and, in truth, they are profit distributions, then they are not governed by the principles applicable to bonds and interest

payments. The legal rights and duties themselves—not what they are called—must be examined; on the face of the agreement, they alone are decisive. *Hazel Atlas Glass Co.* v. *Van Dyk & Reeves,* 8 F. 2d 716, 720 (C. C. A. 2d), certiorari denied, *sub nom. Van Dyk* v. *Young,* 269 U. S. 570; *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611, 613 (C. C. A. 2d); *Brown-Rogers-Dixson Co.* v. *Commissioner, supra,* p. 349; *Cass* v. *Realty Securities Co.,* 148 App. Div. 96, 100 (N. Y.), affirmed, 206 N. Y. 649; 6 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 2635. The Treasury Regulations, *supra,* which prohibit the deduction of "so-called interest * * * which is in reality a dividend thereon" have already been discussed. Thus, calling dividends "interest" does not make them interest. *Warren* v. *King,* 108 U. S. 389, 399; *Hamlin* v. *Toledo, St. L. & K. R. Co.,* 78 Fed. 664, 669 (C. C. A. 6th); *Finance & Investment Corp.* v. *Burnet,* 57 F. 2d 444, 445 (App. D. C.); *Mathews* v. *Bradford,* 70 F. 2d 77, 79 (C. C. A. 6th). In this light let us examine the legal rights and obligations expressed in the contract under consideration.

1. There is no certainty that the holder will receive a periodic return. The contract provides that "interest" is payable annually on December 31 of each year (R. 17)—

> out of the net income of the Company, at the rate of 8% * * * *conditioned,*

> however, upon the *net income* of the Company *being sufficient during any interest period* to pay the amount due as interest, in accord with the terms and provisions hereof. The interest on this Income Debenture shall *not* be *cumulative*. [Italics supplied.]

Thus, the payment of so-called "interest" is not merely dependent upon there being earnings, i. e., gross earnings, but upon there being profit, i. e., "net income". The payments accordingly are limited exclusively to a distribution of the corporate earnings or profits during a given year. Characteristically such distributions are dividends. As the court said, in *Bakers' Mutual Coop. Ass'n* v. *Commissioner, supra* (p. 28):

> The taxpayer argues that even if there was not an unconditional obligation to pay interest on the certificates, certainly there was an obligation to pay the interest if there were profits. But such a distribution of corporate earnings comes within the definition of a dividend in the Revenue Act 1932, § 115, 26 U. S. C. A. Int. Rev. Acts, page 520, and therefore this argument is unavailing.

Further, the payments do not even possess the assurance of preferred dividends,[3] but like common stock, dividends are not cumulative. Should

[3] Preferred dividends, unless express provision is made to the contrary, are cumulative. 1 Cook, Corporations (8th Ed.), Sec. 273; 12 Fletcher, *supra*, Sec. 5447.

there be no net income for a given annual period, no claim for payment survives; neither may it be asserted at the time of the alleged "maturity" of the security. The certificate holder here assumes the risks of a proprietor. He is merely an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no return upon his money whatsoever.

Interest is a certain payment whose amount is known in advance; here, on the other hand, the parties never can know, except as a maximum, the amount payable in advance; in addition, being noncumulative, no one can compute—even assuming solvency—the definite amount of income, which will be received, over the approximate twenty years of the agreed term. The same is true of common stock. In holding that similar provisions constituted dividends, not interest, the Circuit Court of Appeals for the Sixth Circuit in *Hamlin* v. *Toledo, St. L. & K. R. Co., supra,* said (pp. 669–670):

> That these shares are declared to carry "interest at the rate of four per cent. per annum, payable semiannually, represented by coupons attached," is not conclusive that they are debt obligations. By calling a dividend "interest," the essential nature of the thing is not changed. We must look deeper. When we do so, we find that this "interest" is to be paid only out of "the net earnings" after paying interest upon the

> first mortgage bonds, "and the cost of maintenance and operation." We further find that this so-called "interest" is "noncumulative." The net earnings of each year are to be ascertained. If there are none, after paying interest on the first mortgage bonds and operating expenses and expenses of maintenance, no "interest" is to be paid; and when, at any time, such a happy state of affairs is found to exist as a surplus, so that anything can be paid upon the current year's "interest," all past due coupons for "unearned interest" are to be surrendered. Thus, this "interest" has all the characteristics of a preference, in dividends to the extent of four per cent. per annum, over the common stock, and none of the marks of interest proper.

Moreover, as in the case of dividends, the distribution is essentially dependent upon the directors' discretion, which, if exercised in good faith, the certificate holder cannot control. As said in *Spies* v. *Chicago & E. I. R. Co.*, 40 Fed. 34, 38 (C. C. S. D. N. Y.):

> *An income railway mortgage,* * * * *is, as a security for the payment of interest, but little more than the pledge of the good faith of the company in managing its lines.* It necessarily contemplates that such improvements as seem necessary to the efficient use and operation of such property, and such alterations in the *corpus* as appear desirable, are to be made, at the discretion

> of the directors; and unless it contains some limitations upon the powers of the directors, express or implied, the right of the company to conduct its operations as it may see fit, subject only to the conditions of its organic law, is unqualified; and consequently the company can lawfully extend its lines, acquire new ones, discontinue old ones, and thus essentially change the earning capacity of the property. [Italics supplied.]

There are here no contractual restrictions on the power of the directors. Such income payments are further subject to the directors' discretion to retain portions of gross income as reserves against depreciation. *Whitridge* v. *Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302, 310 (Md.).

Since the "bonds" are to run for approximately twenty years and the earnings are to be determined at the end of each year, in the meantime, certainly, it was not intended that the business remain stationary. Precisely as in the case of dividends, the exercise of the directors' discretion as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation and other reserves, and what balance remains as *net* income for distribution to holders of these securities, is unlimited in the absence of bad faith. A mistake in judgment as to the necessity or extent of

expenditures will afford no ground of complaint by the security holders. The power of control by the directors, as compared to that existing in the case of stockholders, is substantially unimpaired, and as a practical matter, it is left to them to ascertain whether any of the company's earnings shall be paid to these certificate holders. *Union Pacific R. R. Co.* v. *United States*, 99 U. S. 402, 404, 420–423; *Day* v. *O. & L. C. R. R. Co.*, 107 N. Y. 129, 146–148; *Thomas* v. *N. Y. & G. L. R. Co.*, 139 N. Y. 163, 183–184; 6 Fletcher, *supra*, Sec. 2645.

In truth, securities providing for income payments of this character "bear a close resemblance to capital stock" [4] (6 Fletcher, *supra*, Sec. 2644, p. 476). See also 4 Cook, *supra*, Sec. 773, p. 3520:

> The same difficulty that is experienced in ascertaining whether there are net profits for a dividend is experienced in ascertaining whether there is a surplus properly applicable to income bonds.

Thus, irrespective of whether "income bonds" may in some instances be considered "indebtedness", we contend that the noncumulative provisions of the instant securities, combined with their other features, establish them to be stock, rather than bonds.

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[4] An income "bond" was held preferred stock within the meaning of the New York inheritance tax statute in *Matter of Collier*, 112 Misc. 70, 72–74 (N. Y.), following *Cass* v. *Realty Securities Co.*, *supra*, pp. 100–101.

2. It is immaterial that the contract did not authorize the certificate holders to participate in the management of the business. Such is commonly the case with preferred stockholders. *Commissioner* v. *Schmoll Fils Associated, supra,* p. 613.[5] Again, preferred stock issues frequently contain, as here, an agreement against future encumbrance of the corporate property. (R. 23.) *Hamlin* v. *Toledo, St. L. & K. C. R. Co., supra,* p. 670; *Kentucky River Coal Corp.* v. *Lucas,* 51 F. 2d 586 (W. D. Ky.), affirmed without opinion, 63 F. 2d 1007 (C. C. A. 6th).

On the other hand, the covenant in the trust indenture that (R. 23)—

> so long as any of the debentures issued hereunder are outstanding it [the company] will pay to the holders thereof the full amount of interest stipulated to be paid therein before it shall declare a dividend to the holders of the common stock of the Company

is meaningless if these certificates actually constitute indebtedness, since, if the obligation to pay net income is absolute, as taxpayer claims, no such protection is requisite. However, if the instrument, as the Government contends, creates the rights and obligations of preferred stock, then the clause quoted from the agreement possesses

[5] As a matter of fact, the certificate holders, a small family group, were the managers of the business, since the corporate resolution authorizing issuance of the debentures prescribed that they be offered to shareholders only. (R. 35, 57.)

significance. As this court said in *Warren* v. *King, supra,* (pp. 398–399):

> The interest to be paid to them is not to be paid absolutely, as to a creditor, but only out of net earnings, the same fund out of which the dividends on common stock are to be paid. Though called "interest", it is really a dividend, because to be paid on stock and out of net profits.

3. Finally, a right to payment at a definite time is recognized as a proper and not uncommon provision of preferred stock, always subject, by implied or as here by express agreement, to the rights of all creditors. The certificate remains, nevertheless, stock, not indebtedness. *Kentucky River Coal Corp.* v. *Lucas, supra,* p. 588; *Finance & Investment Corp.* v. *Burnet, supra,* p. 445; *Pacific Southwest R. Co.* v. *Commissioner, supra; Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182 (C. C. A. 7th); *Craig* v. *Sheller Wood Rim Mfg. Co.,* 98 Ind. App. 310, 320;[6] *Crimmins & Peirce* v. *Kidder, Peabody Ac. Corp.,* 282 Mass. 367, 374–376. The certificate holders are here precisely in the position of such preferred stockholders. At "maturity" they "rank" inferior, not to a class or classes of secured creditors, or to some creditors, but to "all creditors", superior only to other stockholders. (R. 18.) If

[6] Taxpayer is an Indiana corporation (R. 34); the court below, sitting in a circuit which includes Indiana, noted that preferred stock, having maturity date, is authorized by Indiana law (R. 58).

misfortune overtakes the company, their investment is subject to the payment of every debt. In *Fidelity Savings & Loan Ass'n* v. *Burnet*, 65 F. 2d 477 (App. D. C.), where the right of withdrawal existed at any time—not postponed to a date approximately twenty years hence—the Court of Appeals of the District of Columbia held the certificate to represent stock, not indebtedness. There also, income was payable out of earnings (p. 480), while the shareholder (p. 481)—

> had, it is true, the advantages of withdrawal which the holder of permanent stock did not have, but this advantage accrued only during the solvency of the corporation.

The remedies afforded the certificate holders here do not differ materially from those frequently accorded preferred stockholders. Indeed, the remedy of a preferred stockholder to enforce payment of his dividend is ordinarily more substantial than that here afforded the certificate holder to compel payment of his so-called interest. *W. Q. O'Neall Co.* v. *O'Neall*, 108 Ind. App. 116; 12 Fletcher, *supra*, Sec. 5451. As a matter of fact, the trust agreement affords no remedy by suit for the collection of a so-called interest instalment in the event of nonpayment. If such default continues for a period of two years, then the trustees may, or upon written request of holders of 25% in principal amount of the certificates then outstanding, must demand payment of the principal

amount.[7] (R. 24–25). However, similarly, in the event of default in dividend payments, preferred stockholders are by agreement frequently given control of the company and are in a position to compel dissolution and withdrawal of their investment.[8]

Moreover, no "default" in the sense in which that word is understood in the case of a debt is possible, for the certificate holders' rights are not absolute but are dependent upon the taxpayers' discretion and good faith. Thus, no "default" can occur in the payment of "interest" unless, as already noted, the directors in the exercise of broad managerial discretion permit income to remain unexpended at the end of a given year and thereafter fail to pay to the certificate holders such surplus income; furthermore, the right to payment is always subordinate to the claims of general creditors.

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[7] Before the maturity date expressed in the certificate, no holder has the right to sue on the instrument unless the trustees fail to act after 25% of the certificate holders have made written request to the trustees and offered indemnity. (R. 27.)

[8] Cf. *United States* v. *South Georgia Ry. Co.*, 107 F. 2d 3, 5 (C. C. A. 5th), where the court said:

"The certificates contain provisions usual in preferred certificates for cumulating the dividends and for giving the preferred shareholders the right to take measures to protect their rights as holders of preferred stock, extending to causing the appointment of a receiver for, and if necessary, liquidating the company."

See also *Pacific Southwest R. Co.* v. *Commissioner*, *supra*, p. 817.

To summarize, no case has been found in the federal courts, where noncumulative payments out of net income have been allowed as interest deductions. Indeed, outside of the instant case, the only holding in the Tax Court to the contrary is a memorandum decision, *S. Glaser & Sons, Inc.* v. *Commissioner,* decided May 22, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44, 170). (R. 59.) Nor has an unsecured contract been held to be an indebtedness within the meaning of the revenue laws where, as here, withdrawal of investment is subject to claims of all creditors and where the so called interest is in large measure discretionary, being noncumulative and payable only out of net earnings, limited to an annual period.

C. The Tax Court employed factors which are of no legal significance and ignored other relevant factors

In its opinion the Tax Court listed what it termed "the determining factors" (R. 40), and then proceeded to comment upon them. It did not indicate the weight to be ascribed to any factor. It disposed of the factors, which would have supported a conclusion contrary to that which it reached, by a simple statement that each in itself was not decisive. It failed to list and take into account other factors with respect to which it had made findings of fact and which the court below believed to be important. In a case where the facts may be subjected to several

tests, all having legal significance, and when after being so tested, some point in one direction and others in a different direction, we do not doubt that the decision of the Tax Court is entitled to controlling weight. But that is not to say that the reviewing court is precluded from determining whether or not the various tests which the Tax Court has applied are themselves, in the light of the findings, of legal significance. It is one thing to weigh the evidence, but whether or not a given factor, which is expressly applied to the evidence, is entitled to any legal significance under the findings, is another matter. The Circuit Court of Appeals did not undertake to weigh the factors which the Tax Court relied upon; on the contrary, it held only that the factors which the Tax Court thought should be applied are as a matter of law without significance. Accordingly, we submit that the method which the Tax Court here expressly employed in testing its fact findings and its application are here arbitrary and amply justify reversal by the court below.

The determining factors which the Tax Court listed and applied as tests are[9] (R. 40)—

[9] Compare Treasury Regulations 109, relating to the Excess Profits Tax under the Internal Revenue Code as amended by the Second Revenue Act of 1940, applicable to the taxable years beginning after December 31, 1939, i. e., to taxable years subsequent to those here involved, reading as follows (Sec. 30.719–1 (b)):

"Whether outstanding certificates designated by such names as 'denbenture preferred stock' or 'guaranteed pre-

the name given to the certificates, the presence or absence of maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties.

1. The name given to an instrument is of little importance, as already noted, *supra*, pp. 26–27. The legal rights and duties which the agreement creates—not what they are called—are the determining factors. Moreover, since there was no consistency in the use of the name here, the "debentures" sometimes being called "stock" (R. 36), the name given could not reasonably support taxpayer's contention; at the most it is a neutral factor.

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ferred stock' constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors."

Section 35.719–1 (d) of Treasury Regulations 112, likewise relating to the Excess Profits Tax under the Internal Revenue Code as amended for taxable years beginning after December 31, 1941, is identical. Section 719 of the Internal Revenue Code, to which this regulation refers, provides for the inclusion in invested capital for excess profits tax purposes of 50% of borrowed capital. The regulation thus follows the court decisions, which have interpreted the interest deduction.

2. The maturity date could not on this record reasonably be held to constitute a positive factor indicating a distinction between bond and stock, for, as already noted, *supra,* pp. 34–35, a right to payment at a definite time is not unusual today for preferred stock and is in fact authorized by Indiana corporation law. Besides, here at maturity the certificate holders are precisely in the position of preferred stockholders, ranking inferior to all creditors, superior only to other stockholders. No significance as a matter of law in support of a holding that these instruments are indebtedness can here be given to the maturity date, since if enforcement rendered the corporation incapable of meeting its obligations, the right of the holders would precisely as in the case of preferred stock be subordinated to the rights of general creditors. *Kentucky River Coal Corp.* v. *Lucas, supra.*

3. The source of the payments here is a factor which clearly points in the direction of classifying these debentures as stock, *supra,* pp. 28–32. So-called interest is to be paid only out of income and only out of such net income as may remain after the exercise of managerial discretion by the directors, substantially as in the case of dividends on stock. Once the annual period has passed lacking such net income, no claim for payment survives; neither may it be asserted at the time of the alleged "maturity" of the security. The Tax Court disposed of this factor merely by the comment that it "is not decisive". (R. 40.) How-

ever, even if, *arguendo,* we agree, nowhere did the Tax Court in its express application of these separate determining factors point to any other factors sustaining the opposite conclusion which clearly outweighed it.

4. Neither in the circumstances does the right to enforce payment of principal and interest in the case of default afford positive support to the Tax Court's conclusion. As discussed *supra,* pp. 35–37, the remedy of a preferred stockholder to enforce payment of his dividend is ordinarily more substantial, than that here afforded the certificate holder, to compel payment of his so-called interest. Besides, by reason of the express terms of the agreement, the certificate holder's rights upon default in payment of interest are not absolute, for "interest" is dependent upon taxpayers' discretion and good faith. Again, the remedy afforded as to principal at maturity is assimilated to the remedy of preferred stockholders upon failure of a corporation to redeem at maturity, for the latter also are frequently given the right to compel return of their investment by liquidation, however, always as here, subject to the rights of creditors. Certainly this factor does not justify classifying the certificate holders as stockholders.

5. Again, the status of the certificate holders inferior to that of ordinary corporate creditors is glossed over by the Tax Court's observation that it "is not of itself conclusive". (R. 40.) Here too, the Tax Court in applying the test of the

determining factors has not explained what other factors outweigh this clear weakness in the taxpayer's case.

6. The circumstance that debenture holders did not have a right to participate in management does not distinguish them from preferred stockholders, who commonly are deprived of these rights. Indeed, the facts which the Tax Court found indicate the contrary to be the case here, namely, that the debenture holders, a small family group, are the managers of the business, and the corporate resolution, limiting issuance of the debentures to shareholders only, assured this result. (R. 35, 57.)

7. With respect to the factor of "intent of the parties" (R. 40), the Tax Court made a final comment (R. 40):

> It is apparent that the holders of the preferred stock, in exchanging the stock for "20 year 8% income debentures," preferred the debtor-creditor status of debenture holders to that of stockholders, and stockholders have the right to change the creditor-debtor basis, though the reason may be purely personal to the parties concerned.

However, the question is whether the rights and obligations which the contract creates amount to an indebtedness, not what the parties "intended". We think it clear error for the Tax Court to hold that the personal preference of the stockholders can sustain a conclusion that the instrument is a

debt, not stock. A corporate taxpayer having the burden of establishing that it comes within the class for whose benefit a deduction is allowed does not carry that burden by establishing merely that its stockholders "preferred" the debtor-creditor status. On the contrary, the exchange of the preferred stock for the debentures did not affect in any substantial way the previously existing interest of the stockholders.

The business was a closely held family corporation, all the outstanding common stock being owned by Roy Kelley, his wife, Birdena, and his sister, Mabel. The preferred stock was all owned either individually or as trustee by Roy Kelley and his sister. (R. 34–36, 56.) She was president of the company and he was secretary, and they, plus one of her daughters, constituted its board of directors. (R. 35, 56.) The trust indenture, underlying the certificates, was signed on behalf of taxpayer by Roy Kelley and his sister; they also were appointed the trustees and likewise signed the indenture in that capacity. (R. 30, 35, 56.) The only persons, who by corporate resolution were permitted to subscribe to the new certificates, were shareholders of the company. (R. 35, 57.) Hence, the new issue could involve no change in management; the holders of the "debentures" were in fact the managers of the business. Moreover, the issue involved the raising of no additional capital because the subscriptions by Mabel Ronald and Mrs. Kelley for $24,408 and $10,944 of the new certificates in excess of exchanges of

preferred stock were paid by a credit of dividends on the common stock owned by them. (R. 35, 36, 57.) No substantial business purpose and only one of tax avoidance appears for this retirement of the 6% preferred stock in exchange for 8% debentures by a small, well-established company, in a good credit position, engaged in a retail business, which was able in a slack business year to pay a cash dividend of $55 and a stock dividend of 3½ shares for one. (R. 36, 37, 57.)

The Tax Court completely failed to take these factors into account. There is certainly an air of unreality to the entire transaction which justifies the opinion of the Circuit Court of Appeals that it was nothing but "accounting hocus-pocus". (R. 59.)

The court below in no way controverted the fact findings of the Tax Court; on the contrary, it made the only holding based on the Tax Court's findings which is legally sufficient, namely, a holding that the transaction did not involve the payment of genuine interest on a genuine indebtedness. *Equitable Society* v. *Commissioner, supra,* pp. 563–565; *Commissioner* v. *Scottish-American Co.,* 323 U. S. 119, 124. The Circuit Court of Appeals has not undertaken to re-weigh the factors which the Tax Court relied upon. Where the record, as here, is destitute of evidence to support a finding—the taxpayer having the burden—it was the duty of the reviewing court to reverse an order resting upon such a finding.

D. The question whether the contract was an "indebtedness" turns on the meaning of that word as used in the statute and is therefore a question of law

Moreover, the Government not only contends that the court below properly reversed the Tax Court, since its treatment of the evidence was arbitrary in holding as determinative separate factors which here as a matter of law are not entitled to significance, and since the record does not afford substantial support to the conclusion which it reached, but further urges that whether the agreement creates "indebtedness" within the meaning of the statute, is a question of law which the court below rightly decided and the Tax Court incorrectly decided.

The terms of the agreement are in writing, were all found by the Tax Court and are not challenged. (R. 55.) The question whether these contract terms, as thus found by the Tax Court, provide for payment of "interest" on an "indebtedness" depends upon the meaning of these words as used in the statute, and (*Trust u/w of Bingham* v. *Commissioner*, No. 932, decided by this Court June 4, 1945, not yet reported)—

> are therefore questions of law, decision of which is unembarrassed by any disputed question of fact or any necessity to draw an inference of fact from the basic findings.

The case is not one for the weighing of evidence and the resolution of testimonial differences, in which the court below would have been bound by the facts as the Tax Court found them, but one

for determination of the legal effect of the language, as contained in the uncontroverted agreements in writing. *Hazel Atlas Glass Co.* v. *Van Dyk & Reeves, supra,* p. 720. The legal conclusion to be drawn from the terms used is for the court. *Baker's Mutual Coop. Ass'n* v. *Commissioner, supra,* p. 28; *Commissioner* v. *Meridian & Thirteenth R. Co., supra,* pp. 188–189. The determination by the Tax Court of the rights and obligations arising from a written contract has, moreover, repeatedly been held to be a question of law subject to appellate review. *Midwood Associates, Inc.* v. *Commissioner,* 115 F. 2d 871, 872 (C. C. A. 2d); *Crabb* v. *Commissioner,* 121 F. 2d 1015 (C. C. A. 5th); *Eastern Gas & Fuel A.* v. *Commissioner,* 128 F. 2d 369, 373 (C. C. A. 1st); *Welsbach Eng. & Management Corp.* v. *Commissioner,* 140 F. 2d 584, 586 (C. C. A. 3d), certiorari denied, 322 U. S. 751; *Lum* v. *Commissioner,* 147 F. 2d 356 (C. C. A. 3d).

Again, Congress has here incorporated familiar common law conceptions of contract and property law into the revenue act, which long have on common law principles been the subject for consideration by courts generally.[10] Hence, these questions do not fall peculiarly within the special competence of the Tax Court. See Paul, *Dobson* v. *Commissioner:* The Strange Ways of Law and Fact, 57 Harv. L. Rev. 753, 847–848 (1944).

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[10] For example, cf. 6 Fletcher, *supra,* Sec. 2635; 11 Fletcher, *supra,* Sec. 5294; 1 Cook, *supra,* Secs. 267, 273.

In the *Bingham* case, *supra*, this Court recently said:

> Since our decision in the *Dobson* case [*Dobson v. Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231] we have frequently re-examined, as matters of law, determinations by the Tax Court of the meaning of the words of a statute as applied to facts found by that court.

citing in a footnote a number of such instances.[11] In *Fondren* v. *Commissioner*, 324 U. S. 18, and *Commissioner* v. *Disston*, No. 589, decided June 4, 1945, not yet reported, this Court considered the provisions of particular trust agreements for the purpose of determining whether, within the meaning of the gift tax statute there involved, the obligations, which they expressed, amounted to "future interests". Again, in *Commissioner* v. *Estate of Field*, 324 U. S. 113, the question of law was whether the obligations of a particular trust agreement within the meaning of the relevant Revenue Act constituted a transfer intended to take effect in possession or enjoyment at or after death. Cf. *Fidelity Co.* v. *Rothensies*, 324 U. S. 108, 109–110. In the *Bingham* case, the question was whether under the terms of the particular trust, property was held for the production of income within the meaning of the Revenue Act. Here, the question is what the statute means by "indebtedness", and to re-examine as a matter of law the determination by the Tax Court of this

[11] *Bingham* case, *supra*, fn. 1.

meaning as applied to the agreement found by that tribunal.

These cases may be contrasted with *Commissioner* v. *Scottish American Co.*, 323 U. S. 119, where no problem of legal obligation or property right was involved, nor of construction of a written agreement; but whether or not on a state of substantially undisputed facts the Tax Court was entitled to infer that taxpayer corporations had or had not, as a matter of fact, an office or place of business within the United States during the years in question. The ultimate question there was not one of legal obligation or of property right, but of the existence of a particular state of facts. Thus, this Court said (pp. 123, 125):

> The sole issue revolves about the propriety of the inferences and conclusions drawn from the evidence by the Tax Court. * * *
>
> * * * * * *
>
> We cannot say that it was unreasonable for the Tax Court to conclude that this office was more than a sham and that it was used for the regular transaction of business. Hence it was proper as a matter of law for the Tax Court to classify the taxpayers as resident foreign corporations under § 231 (b).

Clearly the decision there did not turn, as does the question here, upon the determination of whether or not a contract gives rise to certain legal obligations within the meaning of the statute, but on whether (p. 124)—

> the *factual* inferences and conclusions of the Tax Court are supported by substantial evidence. [Italics supplied.]

The question of law here is whether on the basis of the provisions of the agreement, the income payments sought to be deducted were "indebtedness" within the meaning of the Revenue Acts involved. While it is true that no two agreements are exactly alike, the dispute here does not therefore become factual. Cf. *Fondren, Disston, Field* and *Bingham* cases, *supra*. The principle of the law involved is the meaning of the statute, and to hold that the contract here constitutes an indebtedness will materially alter and expand in general the meaning of "indebtedness" in the law.

II

THE CONTRACT DOES NOT AS A MATTER OF LAW REQUIRE THE PAYMENT OF "INTEREST"

The opening sentence of the Tax Court's opinion stated the issue of the case at bar to be only (R. 39)—

> If the debentures have created an indebtedness the payments to the holders thereof are interest and deductible as expense, but if they are in fact capital stock the payments are dividends and not deductible.

Thus, the Tax Court assumed as a matter of law that if the taxpayer's "income debentures" evidence "indebtedness" the payments made thereon

were necessarily "interest"; and it was on that assumption of law that it held that they were. We think that such assumption was erroneous; and that our contention in the court below that it was erroneous raised an issue of law which that court was authorized to consider and pass upon.

Hence, even assuming, *arguendo,* that these certificates represent an indebtedness, payments of this uncertain, indefinite, and discretionary character limited to corporate earnings cannot as a matter of law constitute "interest" within the meaning of the statute. Congress has allowed a deduction only of "interest" and proof that the payment is an "interest" payment remains the primary prescription of the statute; it is not enough for taxpayer to establish that an "indebtedness" exists and that a sum, which is not "interest", has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon him to establish that he has paid strictly "interest". This Court has held that "interest" is used in this statue in its "usual, ordinary and everyday meaning" (*Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 561); and that (p. 560) "the usual import of the term is the amount which one has contracted to pay for the use of borrowed money."

Again, in *Deputy* v. *duPont, supra,* this Court said (p. 498): "We are dealing with the context of a revenue act and words which have today a well-known meaning." Thus, all carrying charges

are not interest (*Deputy* v. *duPont, supra,* p. 497), nor amounts ascribed to a time period prior to the date the loan was made (*Commissioner* v. *Drovers Journal Pub. Co., supra*), although the contract for the use of the money includes a binding promise to pay them. Such agreements do not fall within the ordinary meaning of the term in the context of the statute.

In the context of the pertinent Revenue Acts and of the long-standing Regulations construing them, so-called "interest", which is in reality a dividend, cannot be deducted. The deduction which Congress intended was not a contingent, discretionary distribution of earnings and profits, but a fixed and definite charge, known in advance, collectible absolutely, as a debt against the taxpayer's entire assets, in the nature of a cost of the business.

This Court has recently held in *Equitable Society* v. *Commissioner,* 321 U. S. 560, 564, *supra,* that—

> payments made wholly at the discretion of the company have a degree of contingency which the notion of "interest" ordinarily lacks

even though there (p. 564) "the obligation to pay the principal amount * * * was absolute", and the so-called "interest" was not conditioned on the existence of surplus or earnings. In the instant case the analogy to dividends is more perfect in the respect that the payments could be

made only out of earnings, and indeed, the source of the payments is even more limited than is commonly true in the case of dividends, for here the payment may not be made out of surplus or earnings of past years, but is restricted to "the net income * * * during any interest period" (R. 17), i. e., during a given calendar year. Moreover, as also already discussed, the directors' discretion is substantially as broad and untrammeled as that accorded in the case of dividend declarations; in practice, the only distinction is a formal one. In both cases the amount to be distributed is a balance remaining after the directors have exercised their unlimited judgment in the use of the gross corporate earnings for expenses, repairs, current obligations, and reserves; in the case of the dividend, a formal declaration is necessary, but this, particularly where the stock is preferred, may not arbitrarily be denied. As the Second Circuit Court of Appeals said, referring to similar income provisions (though there cumulative), in *Schmoll Fils Associated, supra* (p. 613):

> Almost the only difference between the debenture holders and holders of cumulative preferred stock is that the former may require payment of their interest out of any net earning of the company, whereas preferred stockholders are able to compel payment of a dividend only in case the directors arbitrarily refuse to declare it.

The administration of a great revenue system is an intensely practical matter; Congress did not intend a shadowy distinction of this character to be treated as real. These income payments are clearly not comprehended within the meaning of "interest", as used in the statute. They are in reality dividends and pursuant to the long-standing Regulations, they are not allowable. These payments are here contingent upon (a) the existence of earnings; (b) their existence during a given calendar year (uncertainties additional to those present in the *Equitable Society* case); and (c) the exercise of managerial discretion by directors substantially as broad as that which exists in the case of dividends on stock. To expand the meaning of the term "interest" to include the payments involved in the instant case, as this Court said in the *Equitable Society* case (p. 564), "would indeed relax the strict rule of construction which has obtained in case of deductions under the various Revenue Acts." Certainly, the instant agreement does not satisfy a strict rule of construction; and Congress intended strictly "interest" to be deducted and nothing else. An obligation, limited to distribution of earnings of a given year, which amounts to "but little more than the pledge of the good faith of the company in managing" its business (*Spies* v. *Chicago & E. I. R. Co., supra,* p. 38), does not conform to the businessman's notion of

interest, nor fall within the purview of the statute.

Finally, in *Equitable Society* v. *Commissioner, supra,* which originated in the Tax Court, this Court decided the question whether (p. 564)—

> on the basis of the provisions of policies and the meager stipulation that the excess interest dividends were "interest" within the usual meaning of the Act as a matter of law.

Substantially this is the question of law here, namely, whether on the basis of the provisions of the agreement, the income payments sought to be deducted were "interest" within the meaning of the Revenue Acts involved. As already noted, this Court has frequently re-examined, as a matter of law, determinations by the Tax Court of the meaning of the words of a statute as applied to the facts found by that court. *Bingham* case, supra.[12] The principle of law involved is the meaning of the statute; to include the payments in the instant case, contingent upon the existence of earnings during a given calendar year and upon the exercise of a broad managerial discretion by directors, amounting to little more than a pledge of good faith, will in general radically alter and expand the meaning of "interest" in all applications.

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[12] Cf. cases cited in fn. 1 of opinion in *Bingham* case, *supra.*

CONCLUSION

The decision of the Circuit Court of Appeals is correct and should be affirmed.

Respectfully submited.

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OCTOBER 1945.

IN THE

Supreme Court of the United States

October Term, 1945.

No. 36.

THE JOHN KELLEY COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

Brief of Amicus Curiae

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SUBJECT INDEX.

A preferred stock certificate issued by an Indiana Company which contains a promise to pay a definite sum at a fixed maturity, evidences a debt and not stock, notwithstanding the Indiana statute which authorizes Indiana companies issuing preferred stock certificates to give them a definite maturity, provided the intention of the issuing company in making the issue is to create indebtedness and not stock.

INDEX OF CASES.

IN THE

Supreme Court of the United States.

October Term, 1945.

No. 36.

THE JOHN KELLEY COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF OF AMICUS CURIÆ.

This case presents a question which is also presented in the case entitled *Petit Anse Company, Petitioner on Review v. Commissioner of Internal Revenue*, now pending in the Circuit Court of Appeals for the 5th Circuit, in which Messrs. Marion N. Fisher of the New York Bar and Joseph S. Clark of the Philadelphia Bar, who are presenting this brief, are the attorneys for the Petit Anse Company.

If the decision in said Kelley case in the Circuit Court of Appeals is affirmed by the Supreme Court of the United States, it will very materially prejudice the position of the Petit Anse Company in its said case now pending in the Circuit Court of Appeals for the 5th Circuit.

In the Kelley case, the taxpayer, the Kelley Company is an Indiana corporation and had outstanding 1110 shares of common stock and 1124 shares of cumulative preferred stock. Said Company issued a series of 20 year "Income Debenture Bonds" aggregating $250,000., bearing interest

at 8% per annum and executed a trust agreement setting forth the terms upon which the debentures were issued and outlining the powers and duties of the Trustees. Said Company exchanged certain of said debentures for its preferred stock at the rate of $102. per share and in its income tax reports thereafter deducted the payments of interest made by it upon said debentures. In the opinion of the court we find the following (p. 467):

> "The sole question presented is whether the payments were interest. There is no dispute as to the facts, and the evidence in the record before us is documentary. Thus a question of law is presented, and its review is clearly authorized by statute. 44 Stat. 110, 26 U. S. C. A. Int. Rev. Code, § 1141 (c) (1). Commissioner of Internal Revenue v. Meridian & Thirteenth Realty Co., 7 Cir., 132 F. (2d) 182, 188."

And again (p. 468):

> "The 8% interest on the debentures was payable *only* out of the net income of the Company. If there was no income, there were no payments, and *defaulted payments did not accumulate.*"

The taxpayer in the Meridian case, which is cited in the opinion in the Kelley case, is also an Indiana corporation, just as the Kelley Company is. In the Meridian case the opinion says (p. 187):

> "Great reliance is placed upon the fact that the stock had a definite maturity date, comparable to a creditor's obligation, which also has a definite date for payment. * * * Again we cite the fact that the Indiana statutes were cognizant of a maturity date as a normal feature of preferred stock and permitted its inclusion in preferred stock issues."

The court also said (p. 188):

> "In passing upon the nature of this corporate obligation we are considering an 'ultimate finding' (Helver-

ing, Com. v. Tex-Penn Oil Co., 300 U. S. 481, 57 S. Ct. 569, 81 L. Ed. 755),—in effect it is a conclusion of law."

It is true that in this case the debentures presented for interpretation contained a promise to pay a definite sum at a fixed maturity, but the fixed maturity authorized for preferred stock by the Indiana statute was held by the court to eliminate the ordinary force and effect of a fixed maturity under similar circumstances. It seems reasonably clear that if there had not been a statute of this kind in Indiana, the existence of the maturity date would have had a very material effect upon the interpretation of the preferred stock certificates.

The last paragraph of the opinion in the Kelley case reads as follows (pp. 468-469):

> "No case has been decided where the facts so clearly characterized the document as stock. A consideration of cases in the Circuit Courts of Appeals and the District Courts discloses none where noncumulative payments, payable out of earnings only, have been held to be interest. Every provision of these debentures is a frequent and authorized clause familiar to preferred stock. Viewing this transaction from any angle, it has all the aspects of an issue of restricted preferred stock. In our opinion, payments made on the so-called 'debentures' were dividends within the meaning of section 115 (a) and not interest on indebtedness."

We are unable to agree with this statement. We find a note at the end of the second sentence of the above quotation in the report of the opinion citing twelve cases inserted in the margin, apparently in support of said statement. We analyze these authorities below. In anticipation of that analysis, we call attention to a principle of law which is well established by numerous authorities, that is, that if a written instrument carries a promise to pay a definite sum

at a fixed maturity, that instrument evidences debt and not stock.

1. In *Arthur R. Jones Syndicate v. Commissioner of Internal Revenue*, 7 Cir., 23 F. (2d) 833, where the taxpayer in order to obtain a loan and to circumvent state usury laws handled the transaction as a sale of preferred stock, it was held not to prevent the taxpayer from showing the true nature of the transaction as against the Government claiming that interest payments are in fact dividends. The deduction of the interest in the taxpayer's income tax returns was allowed.

2. In *Commissioner v. O. P. P. Holding Corporation*, 2 Cir., 76 Fed. (2d) 11, the taxpayer made an issue of debenture bonds and deducted the interest in its income tax reports. These bonds had a maturity and bore interest at the rate of 8% per annum. The court said (p. 12):

> "We do not think it fatal to the debenture-holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder."

This case has been cited with approval in a great many other cases.

3. In *Commissioner v. Proctor Shop, Inc.*, 9 Cir., 82 Fed. (2d) 792, the taxpayer made an issue of debenture preference stock carrying cumulative interest and a right of redemption. He deducted the interest in his income tax reports. The court held that the interest was in the nature of interest and not dividends and hence deductible. This case has been cited and approved a great many times.

4. In *Jewell Tea Co. Inc. v. United States*, 2 Cir., 90 F. (2d) 451. The point was whether premiums paid on

retirements of securities are deductible in income tax returns as interest. The court held that where the holders cannot withdraw from a venture without the consent of the rest demanding a fixed sum at some period set in advance, they are not creditors.

5. In *Helvering v. Richmond F. & P. R. Co.*, 4 Cir., 90 F. 971, the court held that so-called "guaranteed stock" issued pursuant to a Virginia statute which participated in net earnings and had voting power and was secured by a mortgage was interest on outstanding indebtedness, for which income tax deduction was allowable.

6. In *Commissioner of Internal Revenue v. Schmoll Fils Associated*, 2 Cir., 110 Fed. (2d) 611, the taxpayer issued non-maturing debentures providing for payment of 7% cumulative interest exclusively from profits until the debentures were paid or called for redemption.

The court said (p. 613):

> "It is true that the securities here were styled debentures and thus on their face indicated that they represented an indebtedness. * * * The debentures closely resemble cumulative preferred stock in having no maturity date, in being payable exclusively from profits in respect to 'socalled interest'. * * * In short the debenture-holders do not possess the ordinary right of creditors to obtain unconditional payment of their claims at some time."

The court held that the lack of a maturity stamped these debentures as evidencing stock and not debt.

7. In *Commissioner v. Palmer, Stacy-Merrill Inc.*, 9 Cir., 111 Fed. (2d) 809, the taxpayer issued 6% serial promissory notes. In its income tax returns the issuing company deducted the entire amount paid as interest. On the authority of the Proctor Shop case, 82 Fed. (2d) 792, the

court held that the payments of interest were not dividends and were deductible in computing net income.

8. In *Diamond Calk Horse Shoe Co. v. United States*, 116 Fed. (2d) 284, this case was dismissed by the Circuit Court of Appeals for the 8th Circuit by a per curiam order reading:

> "Appeal from District Court docketed and dismissed without taxation of costs in favor of either of the parties per stipulation."

9. In *Commissioner v. Bray*, 5 Cir., 126 Fed. (2d) 612, the Bray Company had made an issue of debenture preferred stock certificates which had a definite maturity date and were issued pursuant to plan for change of capital structure of corporation. The certificates provided for payment of 8% cumulative interest and provided for suit to enforce payment of principal and accumulated interest in event of default. The Tax Court held that the payments on the certificates were not dividends but interest. The sole question presented was whether the Tax Court erred in holding that such payments were payments of interest and deductible from gross income in income tax reports. The Circuit Court of Appeals affirmed the decision of the Board of Tax Appeals and held that these payments were properly deductible.

In its opinion the court said (p. 613):

> "Cases involving deductions under Section 23 (b) are to be decided upon their own facts. As pointed out by this court in United States v. South Georgia Ry. Co., supra (107 F. 2d 6) the question for decision in cases of this kind is 'not what the payments are called, but what in fact, they are'; and that if the evidence taken as a whole shows a relation of debtor and creditor, 'the payments made on account of that relation, will be interest, no matter how called, while if taken as a whole, the evidence shows a stockholding relation, the pay-

ments made will be dividends, equally no matter how called.' "

10. In *United States v. Title Guarantee & Trust Co.*, 6 Cir., 133 Fed. (2d) 990, the court held that 6% preferred stock payable at a definite maturity and on which the holders had no voice in the corporate management, evidenced debt and not stock and that the returns thereon were interest deductible in income tax reports.

11. In *Commissioner v. H. P. Hood*, 1st Cir., 141 Fed. (2d) 467, we have a case which is practically identical with the Kelley case. The taxpayer issued a series of 7% income debentures and the question was whether interest on these debentures was deductible as interest on indebtedness under Section 23 (b), or non-deductible as being in fact preferred stock dividends. The interest was cumulative and in that respect the case is different from the Kelley case. The debentures provided for payment on a definite maturity and carried interest payable quarterly "only out of and to the extent of the net earnings of the Company". The opinion contains the following (p. 470):

> "The essential feature of a debtor-creditor relation is the presence of a fixed maturity date at which time the holder can demand payment whether or not there are net earnings."

The court also said (p. 469):

> "As defined in 1 Bouv. Law Dict., Rawle's 3rd Rev. p. 784, a debenture is 'any instrument (other than a covering or trust deed) which either creates or agrees to create a debt in favor of one person or corporation of several persons or corporations, or acknowledges such a debt.' "

Since the Hood case was decided in the Circuit Court of Appeals for the 1st Circuit, the Talbot Mills case has been decided by that court and removed by certiorari to this Court. The decision was upon facts very similar to the facts

in the Hood case, but the Circuit Court of Appeals did not undertake to overrule the Hood case. On the contrary, it said in the last paragraph but one of the opinion after discussing certain factors:

> "These factors * * * move us to conclude on the reasoning of the Hood case, supra, that the indebtedness feature is subordinate to the proprietary feature and to hold that the 'interest' on these notes is not 'interest * * * on indebtedness' deductible under § 23 (b)."

Attention should be called to the fact that there was a forceful dissent to the decision in the Talbot Mills case.

12. The note to the Kelley case in which these various authorities are cited also refers to a Tax Court memorandum decision, *S. Glaser & Son, Inc. v. Commissioner of Internal Revenue*, Tax Court Memo. Opinions, Docket No. 2897 (1944), in which the facts were practically identical with the facts in the Kelley case. The written instrument presented for interpretation was a bond which obligated Glaser to pay a definite sum at a fixed maturity. In the opinion in the Tax Court we find:

> "The bond contains the following features: a positive obligation to pay; a definite date of payment; a definite interest rate; upon liquidation the preference of the bonds over stock but inferior to claims of general creditors; non-cumulative interest; interest payable from earnings but only upon the declaration of the directors that such earnings are sufficient to pay the interest; a provision for redemption; and the use of the words 'debenture bonds' and 'interest' in the body of the bond."

The Court below held that the "debenture bond" constituted an evidence of indebtedness and that the payments to the bondholders were payments of interest and deductible. The case has been appealed to the Circuit Court of Appeals for the 10th Circuit.

These cases do not support the statement in the last quotation from the opinion in the Kelley case. If a debenture or a bond provides for the payment of interest out of earnings only, that debenture or bond is an income debenture or bond, a kind of security well known in financial circles from an early date. If said debenture or bond provides that the interest shall be non-cumulative, that means that a deficiency of interest payments for any year because of a deficiency in earnings in said year cannot be made up by appropriating for that purpose an excess of earnings of another year. This principle has also been well understood in financial circles from an early date. Neither feature forms any basis for the conclusion that the debenture or bond evidences stock and not debt.

It therefore appears that in all these twelve cases, except two, being Nos. 4 and 6, the instrument presented for interpretation was held to be a debt and the interest thereon was deductible in income tax reports. The reason for the decision in No. 4, the Jewell Tea Co. case, was that the holders of the instrument could not withdraw from the venture without the consent of the rest demanding a fixed sum at some period in advance. For this reason the court held they were not creditors. In No. 6, the Schmoll Fils case, there was no fixed maturity and whenever that characteristic is present the court has always held that the instrument does not evidence debt but stock. All of the other cases support the principle which we believe to be fundamental, that if a written instrument contains a promise to pay a definite sum at a fixed maturity, that written instrument evidences debt and not stock.

It may naturally be suggested that the Indiana statute should be given the same effect in this *Kelley* case as it was given in the Meridian case, 132 Fed. (2d) 182. The situation, however, is different. The debentures issued in the Kelley case in exchange for preferrd stock certificates were designated "Income Debenture Bonds" and each contained a promise to pay $1000. at a definite maturity date in law-

ful money of the United States at the office of the Company and to pay "interest" at 8% per annum, non-cumulative, out of the income. Compare these characteristics with the preferred stock certificates which were issued by the taxpayer in the Meridian case. They were designated preferred stock and they carried dividends, which were not dependent upon the profits, and on liquidation the preferred stockholders were entitled to receive the par value of the stock or have it set aside before any dividends could be paid upon the common stock. It is true that the Circuit Court of Appeals relied expressly upon the Indiana statute which authorized an Indiana company issuing preferred stock to give it a maturity date. In the opinion in the Meridian case (page 186) the court said:

> "The intent of the parties in the establishment of the relation is of extreme importance, and where, as here, there is a simple explanation for the existence of provisions which might otherwise be associated with a creditor relationship, which explanation disproves that relationship, the ambiguous provisions lose most, if not all, of their weight."

The provisions of the preferred stock certificates issued in the Meridian case, as set forth above, were not exactly ambiguous. They were characteristics which evidenced a preferred stock issue excepting only the maturity date. In the opinion in the Kelley case, which we have quoted supra, and in support of which the court cited the cases we have analyzed above, the court said:

> "Every provision of these debentures is a frequent and authorized clause familiar to preferred stock."

A preferred stock certificate is not usually called a debenture, nor does it bear interest, nor are the preferred stockholders usually given the right to declare the interest due and payable in the event of default. This last provision is a little different from a clause giving preferred stockholders the right to receive in liquidation the par value

of their stock, or have it set aside before any common dividends may be paid.

The opinion in the Tax Court in the Meridian case (44 B. T. A. 865) was written by Murdock, Judge, but Judges Leach and Turner dissented on the point that the debentures evidenced stock carrying dividends, and not indebtedness bearing interest.

It is respectfully submitted that the decision of the Court below should be reversed.

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SUPREME COURT OF THE UNITED STATES.

Nos. 36 and 47.—October Term, 1945.

The John Kelley Company, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.
36	
Talbot Mills, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the First Circuit.
47	

[January 7, 1946.]

Mr. Justice Reed delivered the opinion of the Court.

These writs of certiorari were granted to examine the deductibility as interest of certain payments which the taxpayer corporations made to holders of their corporate obligations. Although the obligations of the two taxpayers had only one striking difference, the noncumulative in one and the cumulative quality in the other of the payments reserved under the characterization of interest, the Tax Court (formerly the Board of Tax Appeals, 56 Stat. 957; only its present name will be used herein) held that the payments under the former, the *Kelley Company* case, were interest and under the *Talbot Mills* were dividends. The Circuit Court of Appeals reversed the Tax Court in the *Kelley* case and another circuit affirmed the *Talbot Mills* decision.[1] On account of the diversity of approach in the Tax Court and the reviewing courts, we granted certiorari.

In the *Kelley* case, a corporation, all of whose common and preferred stock was owned directly or as trustee by members of a family group, was reorganized by authorizing the issue of $250,000 income debenture bearer bonds, issued under a trust indenture, calling for 8% interest, noncumulative. They were

[1] 1 T. C. 457; 146 F. 2d 466; cert. granted, 325 U. S. —; Judicial Code § 240(a). 3 T. C. 95; 146 F. 2d 809; cert. granted, 325 U. S. —; Judicial Code § 240(a).

offered only to shareholders of the taxpayer but were assignable. The debentures were payable in twenty years, December 31, 1956, with payment of general interest conditioned upon the sufficiency of the net income to meet the obligation. The debenture holders had priority of payment over stockholders but were subordinated to all other creditors. The debentures were redeemable at the taxpayer's option and carried the usual acceleration provisions for specific defaults. The debenture holders had no right to participate in management. Other changes not material here were made in the corporate structure. Debentures were issued to the amount of $150,000 face value. The greater part, $114,648, was issued in exchange for the original preferred, with six per cent cumulative guaranteed dividends, at its retirement price and the balance sold to stockholders at par, which was eventually paid with sums obtained by the purchasers from common stock dividends. Common stock was owned in the same proportions by the same stockholders before and after the reorganization.

In the *Talbot Mills* case the taxpayer was a corporation which, prior to its recapitalization, had a capital stock of five thousand shares of the par value of $100 or $500,000. All of the stock with the exception of some qualifying shares was held by members, through blood or marriage, of the Talbot family. In an effort to adjust the capital structure to the advantage of the taxpayer, the company was recapitalized just prior to the beginning of the fiscal year in question, by each stockholder surrendering four-fifths of his stock and taking in lieu thereof registered notes in aggregate face value equal to the aggregate par value of the stock retired. This amounted to an issue of $400,000 in notes to the then stockholders. These notes were dated October 2, 1939, and were payable to a specific payee or his assignees on December 1, 1964. They bore annual interest at a rate not to exceed 10% nor less than 2%, subject to a computation that took into consideration the net earnings of the corporation for the fiscal year ended last previous to the annual interest paying date. There was, therefore, a minimum amount of 2% and a maximum of 10% due annually and between these limits the interest payable varied in accordance with company earnings. The notes were transferable only by the owner's endorsement and the notation of the transfer by the company. The interest was cumulative and payment might be deferred until the note's maturity

when "necessary by reason of the condition of the corporation." Dividends could not be paid until all then due interest on the notes was satisfied. The notes limited the corporation's right to mortgage its real assets. The notes could be subordinated by action of the Board of Directors to any obligation maturing not later than the maturity of the notes. For the fiscal year in question the maximum payment of 10% was made on the notes.

The payments in question on corporate obligations were for the years in the *Kelley* case, 1937, 1938 and 1939; in the *Talbot Mills* case for the year 1940. Both corporations deducted the payments as interest from their reports of gross income under statutory sections and regulations set out in the footnote.[2] The applicable statutes and regulations were identical for all periods. The Commissioner asserted deficiencies because the payments were considered dividends and not interest.

There is not present in either situation the wholly useless temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering*, 293 U. S. 465. The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentiation. As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.

From the foregoing statements of facts, it appears that the characteristics of all the obligations in question and the surrounding circumstances were of such a nature that it is reasonably possible

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[2] Internal Revenue Code:

"SEC. 23. Deductions from Gross Income. In computing net income there shall be allowed as deductions:

"(b) Interest.—All interest paid or accrued within the taxable year on indebtedness. . . ."

"SEC. 115. Distributions by Corporations. (a) Definition of Dividend.—The term 'dividend' when used in this chapter (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year . . . ."

Treasury Regulations 103.

"SEC. 19.23(b)-1. Interest.—Interest paid or accrued within the year on indebtedness may be deducted from gross income, . . .

"So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. . . ."

See Revenue Acts of 1936 and 1938, 49 Stat. 1648, 1659, 52 Stat. 447, 460, and Treasury Regulations 94, Art. 23(b)-1, and 101, Art. 23(b)-1.

for determiners to reach the conclusion that the secured annual payments were interest to creditors in one case and dividends to stockholders in the other case. In the *Kelley* case there were sales of the debentures as well as exchanges of preferred stock for debentures, a promise to pay a certain annual amount, if earned, a priority for the debentures over common stock, the debentures were assignable without regard to any transfer of stock, and a definite maturity date in the reasonable future. These indicia of indebtedness support the Tax Court conclusion that the annual payments were interest on indebtedness. On the other hand, in the *Talbot Mills* case, the Tax Court found the factors there present of fluctuating annual payments with a two per cent minimum, the limitation of the issue of notes to stockholders in exchange only for stock, to be characteristics which distinguish the Talbot Mills notes from the Kelley Company debentures. Upon an appraisal of all the facts, the Tax Court reached the conclusion that the annual payments by Talbot Mills were in reality dividends and not interest.

We think these conclusions should be accepted by the Circuit Courts of Appeals and by ourselves. Judicial review of Tax Court decisions depends upon the Internal Revenue Code, Section 1141(e) Powers (1). It reads:

> "To affirm, modify or reverse.—Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require."

It is only recently that we gave careful consideration to the problems of review of Tax Court decisions. *Dobson* v. *Commissioner*, 320 U. S. 489. That opinion emphasized that our interpretation of Congressional purpose, in enacting the statute, just quoted for judicial review of Tax Court decisions, was that Congress intended to leave to the final determination of the Tax Court all issues which were not clear-cut questions of law.

The provisions for review are the same now as they were when enacted in 1926. Congress, and all others interested, were then well aware of the difficulties in drawing a line between questions of fact and questions of law.[3] The legislation was upon a subject,

[3] Compare Thayer, A Preliminary Treatise on Evidence at the Common Law, Ch. V, with Holmes, The Common Law, pp. 123-129. 1 Holdsworth, History of English Law, 298, 312; Dickinson, Administrative Justice, c. III, p. 55. "In truth, the distinction between 'questions of law' and 'questions of fact' really gives little help in determining how far the courts will review;

the collection of the revenue, in which federal administrative finality had been given wide scope.[4] The Tax Court was originally established to "secure an impartial and disinterested determination of the issues involved,"[5] so that the taxpayer and the Government would have an independent review of the position of either on tax demands before payment of the tax or foreclosure of an asserted deficiency. Two years later its success was recognized by committee commendation and the enlargement of the finality of its decisions from "prima facie evidence of the facts contained therein," to reviewability only "if the decision of the Board is not in accordance with law."[6] As to the mischief which the limitation of the scope of judicial review was to cure, we find only the words of the committee reports.[7] Without a clearer description by Con-

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and for the good reason that there is no fixed distinction. They are not two mutually exclusive *kinds* of questions, based upon a difference of subject-matter. Matters of law grow downward into roots of fact, and matters of fact reach upward, without a break, into matters of law. The knife of policy alone effects an artificial cleavage at the point where the court chooses to draw the line between public interest and private right."

[4] R. S. §.3224; 26 U. S. C. § 3653; Heiner v. Diamond Alkali Co., 288 U. S. 502; Cary v. Curtis, 3 How. 246.

[5] 5 Rep. No. 398, 68th Cong., 1st Sess., p. 9.

[6] H. Rep. No. 179, 68th Cong., 1st Sess., p. 8; 44 Stat. 110, sec. 1003(b); H. Rep. No. 1, 69th Cong., 1st Sess., p. 17; S. Rep. No. 52, 69th Cong., 1st Sess., p. 34.

While establishing a complete system of review, it has all along been recognized that the taxpayer could secure a jury trial of fact issues, if he chose to pay and sue for recovery. S. Rep. No. 52, 69th Cong., 1st Sess., p. 37. Dobson v. Commissioner, 320 U. S. 489, 495.

[7] H. Rep. No. 1, 69th Cong., 1st Sess., p. 19-20:

"*Court review—Questions of fact and law.*—The procedure is made to conform as nearly as may be to the procedure in the case of an original action in a Federal district court. Inasmuch as the complicated and technical facts governing tax liability require a determination by a body of experts, the review is taken directly to an appellate court, just as, for instance, in the case of orders of the Federal Trade Commission, and orders of the Secretary of Agriculture under the packers and stockyards act. In view of the grant of exclusive power to the board finally to determine the facts upon which tax liability is based, subdivision (b) of section 914 limits the review on appeal to what are commonly known as questions of law. The court upon review may consider, for example, questions as to the constitutionality of the substantive law applied, the constitutionality of the procedure used, failure to observe the procedure required by law, the proper interpretation and application of the statute or any regulation having the force of law, the existence of at least some evidence to support the findings of fact, and the validity of any ruling upon the admissibility of evidence (see subdivision (a) of section 907 and subdivision (b) of section 914). [§ 1003(b) of the Act as passed.] The court, therefore, may adequately control the action of the administrative officer or agency, but will not be burdened with the duty of substituting its opinion for that of the board upon the evidence."

Since the Federal Trade Commission and the Packers and ~~Stockyards~~ Acts

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gress of the intended line to separate reviewability of the Tax Court decisions from non-reviewability, courts must interpret the review statute, as best they can, to accomplish the declared Congressional purpose of adequate control of administrative action without substituting judicial opinion for that of the Tax Court upon the evidence. Note 7, *supra.*

The illustrations in the report, note 7, *supra,* are legal questions without doubt, except the possibility that the words "application of the statute or any regulation having the force of law" may be thought to give a reviewing court power to pass upon the Tax Court's conclusion from the primary or evidential facts. So that in the present cases, it might be said to be a question of law as to whether the primary facts adduced made the payments under consideration dividends or interest. But we think such conclusion gives inadequate weight to the purpose of the Tax Court. The finality of the Tax Court's rulings was being enlarged by the 1926 Act. The then Board was spoken of as an impartial and independent tribunal of experts "for the determination of tax liabilities as between the Government and the taxpayer." H. Rep. No. 1, 69th Cong., 1st Sess., p. 17. There would hardly need to be experts in tax affairs to decide questions of dates or amounts or values or to calculate rates. Their usefulness lies primarily in their ability to examine relevant facts of business to determine whether or not they come under statutory language. Adequate reason for the use of the word "application" of course exists in situations where true legal questions arise, as in whether an act applies to transfers antecedent to its enactment or to income or estate taxes from trusts or to situations which involve conflicts of law. There is nothing in the context in which the word "application" is used which suggests to us that it should be given its widest connotation.

These cases now under consideration deal with well understood words as used in the tax statutes—"interest" and "dividends." They need no further definition. *Equitable Life Assurance Society* v. *Commissioner,* 321 U. S. 560; *Deputy* v. *DuPont,* 308 U. S. 488, 498. The Tax Court is fitted to decide whether the annual

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The reference to the Federal Trade Commission and to the Packers and Stockyards Act was to show the choice of a circuit court of appeals for judicial review and was not intended to suggest the adoption for the Tax Court review of any standard of scope of review."

payments under these corporate obligations are to be classified as interest or dividends. The Tax Court decisions merely declare that the undisputed facts do or do not bring the payments under the definition of interest or dividends.[8] The documents under consideration embody elements of obligations and elements of stock. There is no one characteristic, not even exclusion from management which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So called stock certificates may be authorized by corporations which are really debts and promises to pay may be executed which have incidents of stock. Such situations seem to us to fall within the *Dobson* rule.[9]

This leads us to affirm the *Talbot Mills* decree and to reverse the *Kelley* judgment.

It is so ordered.

Mr. Justice BLACK concurs in the result in No. 47. He is of the opinion that No. 36 should be affirmed for the reasons given by the Circuit Court of Appeals, 146 F. 2d 466.

Mr. Justice BURTON concurs in the result in the *Kelley* case but dissents from the result in the *Talbot Mills* case on the grounds stated in the dissenting opinion of Magruder, J., in the Circuit Court of Appeals.

Mr. Justice JACKSON took no part in the consideration or decision of these cases.

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[8] Dickinson, Administrative Justice, 312; Paul, Dobson v. Commissioner; The Strange Ways of Law and Fact, 57 Harv. L. R. 753, 826, 832, 840; Brown, Fact and Law in Judicial Review, 56 Harv. L. R. 899, 904.

[9] Compare Helvering v. F. & R. Lazarus Co., 308 U. S. 252, 255; Wilmington v. Helvering, 310 U. S. 164, 167; Helvering v. Stock Yards Co., 318 U. S. 693, 700, 703; Equitable Society v. Comm'r, 321 U. S. 560, 563; Comm'r v. Scottish American Co., 323 U. S. 119.

SUPREME COURT OF THE UNITED STATES.

Nos. 36 and 47.—October Term, 1945.

The John Kelley Company, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.
Talbot Mills, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the First Circuit.

[January 7, 1946.]

Mr. Justice Rutledge.

I think the judgments in both cases should be affirmed. On the records presented, I can see no satisfactory basis for deciding one case one way and the other differently. And I agree with the Courts of Appeals that, on the substantially identical facts, the payments were dividends and not interest.

In the first place, I do not believe that Congress has authorized the Tax Court to make or the reviewing courts to sustain directly conflicting determinations of tax liability in identical fact situations. Nor, in my opinion, was this the purpose or effect of the *Dobson* decisions, 320 U. S. 489. So to regard them or the statute nullifies the right to review expressly given by Congress. Moreover that view destroys the very uniformity which *Dobson* sought, transferring the conflict of decision from the Courts of Appeals back to the Tax Court, by making the conflicting decisions of its sixteen divisions final.[1] This affords relief to the taxpayer from

[1] The Internal Revenue Code provides that the chairman (now presiding judge of the Tax Court, § 1100) may "from time to time divide the Board into divisions of one or more members" and "a majority of the members of the Board or of any division thereof shall constitute a quorum for the transaction of the business of the Board or of the division respectively." §§ 1103(c), (d). By § 1118(b) the report of a division becomes the report of the Board within 30 days unless the chairman directs that it be reviewed by the Board.

Each of the two cases before us was decided by only one Tax Court judge, a different judge in each case. See Griswold, The Need for a Court of Tax Appeals (1944) 57 Harv. L. Rev. 1153, 1170-1172.

judicial review and to the courts from judicially reviewing. But it defies Congress' mandate for review and, what is more, perpetuates chaos in the law.

All this presupposes, of course, that the records now here present fact situations identical in all material respects. That is true in my judgment. It is hardly necessary to attempt demonstration. But, besides referring to the opinions of the Courts of Appeals for the small details of the facts and their minute differences,[2] it may be noted that there was no question of credibility. Substantially all of the evidentiary facts were stipulated in both cases. Nor is there any finding in either case that the arrangements were a sham. Cf. *Gregory* v. *Helvering*, 293 U. S. 465. Apart from such considerations, the material facts in my opinion were not substantially different in any respect sufficient to support one ultimate conclusion, whether labelled of "law," of "fact," or "mixed," for one case and the opposite conclusion for the other.

That is true whether the final conclusion of "interest" or "dividend" is to be drawn from a minute comparison of, and effort to differentiate, the multitudinous microscopic details by which in both cases it was sought to convert stock into "debentures" or "registered notes," without losing any of the stock's substantial advantages; or, on the other hand, the final plunge of judgment is to be made from wholesale weighing of the evidentiary facts. Neither approach discloses factors of substantial difference in what was done sufficient to sustain contrary judgments.

There were some highly technical differences in the two types of "security" which were devised to replace the preexisting preferred stock issues. But in both instances the original stock and the replacing security were closely held. There was no substantial change in the distribution after the "reorganization." The difference between the stock and the substituted security was so small, in its effect upon the holders' substantial rights, that for all practical purposes it was negligible. For example, a remote right to sue to enforce the obligation, deferred in one case for 25 years, took the place of the holder's right to share in the corporation's assets on dissolution or winding up. Meanwhile "interest" was

[2] 146 F. 2d 466; 146 F. 2d 809.

hooked in large part to net annual earnings and was made entirely subject to the directors' power to suspend payment until the ultimate maturity date. The shortened story is that the preferred shareholders who went into the wash came out substantially, for all purposes material to any tax determination and it may be for practically all others, just about what they were when they went in.

The Court indeed does not attempt to find a substantial differentiating factor other than in the Tax Court's "appraisal of all the facts," in other words its ultimate conclusion. That is true as between the two cases and also as affects the positions of the respective shareholders before and after the wash. Rather the opinion concedes that in each case the circumstances were such that determiners reasonably could conclude that the so-called annual payments were either interest or dividends. Hence, it seems to follow, the conclusion may be drawn in squarely conflicting ways, if the Tax Court sees fit so to draw it; and it is immaterial that no factor of substantial difference is or can be pointed out.

One might entertain the view that in a close situation the Tax Court's judgment should be accepted whatever way the die were cast, although reviewing courts might differ on the direction. But it would not follow, and in my judgment should not, that they are powerless when the throw is in opposite directions at the same time. When this occurs, in my opinion a "clear-cut" question of law is presented, rising above the rubric of "expert administrative determination." The more apt characterization would be "expert administrative fog."

I think the Courts of Appeals and we are bound to review such cases; they by plain mandate of § 1141(c)(1) of the Code, we by that section (see *Bingham's Trust* v. *Commissioner*; 325 U. S. —) and the provision of our rules making conflict between circuits "special and important reason" for granting certiorari. Rule 38-5(b). Conflict is not removed simply because judgments of the Courts of Appeals judicially formalize the contrary ultimate, but nevertheless administrative, conclusions of the Tax Court. When no facts can be pointed to which are sufficient to distinguish Tax Court decisions in legal effect, except that the Tax Court has decided differently in two cases, the Courts of Appeals and we are bound by law and by our duty to exercise a sound discretion in review to resolve the conflict.

Another reason convinces me that both judgments should be affirmed. What has been said applies to conflicting determinations of the Tax Court, whatever the particular line which is to be drawn and regardless of its general location. But in these cases I think that as a matter of law the line should not be located where the Tax Court has placed it.

Tax liability should depend upon the subtle refinements of corporate finance no more than it does upon the niceties of conveyancing.[3] Sheer technicalities should have no more weight to control federal tax consequences in one instance than in the other. The taxing statute draws the line broadly between "interest" and "dividend." This requires one who would claim the interest deduction to bring himself clearly within the class for which it was intended.[4] That is not done when the usual signposts between bonds and stock are so obliterated that they become invisible or point equally in both directions at the same time.

"Dividend" and "interest," "stock" and "bond," "debenture" or "note," are correlative and clearly identifiable conceptions in their simpler and more traditional exemplifications. But their distinguishing features vanish when astute manipulation of the broad permissions of modern incorporation acts results in a "security device" which is in truth neither stock nor bond, but the half-breed offspring of both. At times only the label enables one to ascertain what the manipulator intended to bring forth. But intention clarified by label alone is not always legally effective for the purpose in mind.[5] And there is scarcely any limit to the extent or variety to which this kind of intermingling of the traditional features of stock and bonds or other forms of debt may go, as the books abundantly testify.[6] The taxpayer should show more than a label or a hybrid security to escape his liability.

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[3] Helvering v. Hallock, 309 U. S. 106, 117-118; Smith v. Shaughnessy, 318 U. S. 176, 180.

[4] Interstate Transit Lines v. Commissioner, 319 U. S. 590, 593; see also New Colonial Co. v. Helvering, 292 U. S. 435, 440; Deputy v. du Pont, 308 U. S. 488, 493; McDonald v. Commissioner, 323 U. S. 56, 60.

[5] In re Fechheimer Fishel Co., 212 Fed. 357, 360; In re Collier's Estate, 112 Misc. (N. Y.) 70; Cass v. Realty Securities Co., 148 App. Div. 96, 100, affirmed, 206 N. Y. 649; see Commissioner v. Schmoll Fils Associated, Inc., 110 F. 2d 611.

[6] See Hansen, Hybrid Securities: A Study of Securities Which Combine Characteristics of Both Stocks and Bonds (1936) 13 N. Y. U. L. Q. 407; Uhlman, The Law of Hybrid Securities (1938) 23 Wash. U. L. Q. 182; Jewel Tea Co. v. United States, 90 F. 2d 451, 452-453.

He should show at the least a substantial preponderance of facts pointing to "interest" rather than "dividends."

Something more is at stake in these cases than nice distinctions between "stock" and "bonds" on the one hand or between ultimate conclusions of "fact" and "law" or "mixed fact and law," on the other, just as was true in the conveyancing cases. The border cutting across one set of normally opposing conceptions may be deliberately obscured and made into a no man's land as readily as that involved in the other. When this happens, the final link in the chain of judgment is decisive, whatever its label.[7] If the ultimate conclusion of the Tax Court or its divisions can be made in exactly opposing ways, and must be left undisturbed, without substantial differentiating facts, or when hybrid arrangements bear tax indicia equally with marks of nontaxability, not only is the statutory review nullified. The right of taxpayers to be treated with equal justice before the law is denied.

[7] The legal element is not eliminated merely because it appears in "'a molecular combination of fact and law which defies separation.'" Berry v. Irving Place Corp., 52 F. Supp. 875, 881. It may be the dominant element in the combination. When it is, minutiae of factual difference should not govern result or sustain conflicting outcomes.